

# **Monitoring collective investment schemes**

## **General report on the investigation into collective investment schemes**

## Summary

### Introduction

Over the past decade, the market for collective investment schemes has undergone spectacular growth. Investments have quadrupled to about EUR 100 billion. This figure only relates to the collective investment schemes under the AFM's supervision. Related products such as unit-linked products have also shown strong growth. The section of the population that is entrusting its money to collective investment schemes is getting broader and broader. New products that use specialised investment strategies to try to tap into niche markets are continually being launched. This growth, and the increasing degree of complexity, demands a greater focus on the legislation, and on the way in which collective investment schemes act on it. This is partly due the special features of the Dutch trading system, which differ from other trading systems in a number of ways. In the past, various market players have urged that the Dutch system be reviewed.

Over the past few months, the AFM has carried out investigations into various issues affecting a representative section of the market for collective investment schemes. The group investigated is a mix of both large and smaller providers. The providers are financial institutions. A small number of collective investment schemes have been looked at for each provider. The combining of supervision of conduct of business on the part of securities institutions (regulated by the *Act on the Supervision of Securities Transactions* (Wte) and collective investment schemes (regulated by the *Act on the Supervision of Collective Investment Schemes* (Wtb) gave the investigation an important stimulus; now that conduct of business in respect of both Acts is in the hands of a single body, namely the AFM. A routine investigation carried out in mid-2003 revealed shortcomings at a collective investment scheme, which give rise to the need to carry out a wider investigation into these issues. The need for such an investigation became more urgent as the result of reports emanating for the United States in the second half of 2003, regarding improper trading practices.

The purpose of this report is threefold:

- to provide general information on the AFM investigation
- to prevent the information on the investigation from reaching the outside world in a fragmentary way and out of context, and
- to create a clear starting point for improving the quality of the Dutch market for collective investment schemes.

As many households have put their trust in collective investment schemes, it is of the greatest importance that this trust is not betrayed in any way. Improper trading practices, similar to those uncovered in the United States, would have a disastrous effect on this trust. The AFM's investigation did not provide any indications that the interests of investors had been damaged by *market timing* or *late trading*, in the same way as has happened in the United States. The AFM has not found any instances in the Netherlands of such improper trading practices, in so far as they relate to trading with third parties. However, small-scale *late trading* was found at one or more CIS's. There are no indications that significant damage has been caused to the interests of long-term investors as a result. Furthermore, the findings regarding *late trading* are mainly related to the peculiarities of the Dutch system of trading in units in collective investment schemes.

However, the AFM has indeed discovered that at one or more of the CIS's investigated, there was insufficient safeguarding of investors' interests. In a number of cases, the interests of investors were directly damaged. There are different levels of shortcomings in the collective investment schemes investigated. It is very difficult to estimate the damage caused to the

investor's interests by the shortcomings discovered. Irrespective of the seriousness of the damage, every damage to investors' interests is of course undesirable.

This summary also contains:

- a list of the issues investigated
- a summary of the shortcomings established for each issue investigated, and
- the follow-up measures to be taken.

### **The issues investigated**

The investigation focused on the following issues:

1. Incorporating surcharges and discounts on the purchase and sale of units in collective investment schemes in relation to the information in the prospectus (see chapter 4);
2. Comparing costs charged to investors with the costs advertised in the prospectus (see chapter 5);
3. Pricing and trading with affiliated parties and third parties (chapter 6);
4. Calculating net asset value (chapter 7); and
5. Quality of the administrative organisation (chapter 8).

During the course of the investigation, the shortcomings uncovered raised questions about two related subjects that were not part of the official investigation, namely;

- The governance of collective investment schemes and
- The role of the auditor in collective investment schemes.

### **Shortcomings detected**

It should be noted beforehand that there are two separate stages to the AFM's investigation into the shortcomings detected. The first stage is this report. The shortcomings discussed herein have been submitted to the relevant CIS's in which they were discovered. The CIS's were given the opportunity to submit their response to the AFM. The AFM has incorporated its responses into this report where it deemed it necessary to do so. The second stage relates to the findings for each CIS. These are handled separately from this report, and directly with the relevant parties involved. In most cases, this process has not yet been completed.

The AFM has established different types of shortcomings. One type of shortcoming relates, in our view, to a clear violation of legislation and regulations relating to financial supervision. In addition, shortcomings were detected about which the AFM has serious doubts as to whether regulations and legislation were complied with. In this case, various different interpretations of the legislation and regulations are possible. Where necessary, the AFM will deploy suitable enforcement tools for these two types of shortcomings. Finally, there are shortcomings that the AFM itself characterises as 'undesirable practices', but where there is no basis in the legislation or regulations for banning them. In this report, the AFM shall not distinguish between these three types of shortcomings, but will do so in its dealings with the CIS's involved.

#### **1. Incorporating surcharges and discounts on the purchase and sale of units in collective investment schemes in relation to the information in the prospectus**

The prospectus states that the surcharges and discounts will be incorporated into prices in a particular way. In practice, however, there are one or more instances where it appears that this incorporation is carried out in a different way, whereby the investor is given incorrect information or is disadvantaged:

- In a number of cases, the income that the liquidity provider earns from the system of surcharges and discounts does not flow back to the CIS, even though in one or more cases it may be deduced from the prospectus that it should.

- In many CIS's, it is normal practice that buy and sell orders (usually from the giro-based securities transfer system) are netted out and the orders settled at a single price (*netting*). The collective investment scheme could 'miss out' on income from the surcharge or discount, so long-term investors could be missing out, compared to new investors or those pulling out. In one or more cases, this practice was found to be at odds with the information in the prospectus.
- At many of the investigated CIS's, it was established that the bandwidth set out in the prospectus within which the surcharge and discount may fluctuate, was occasionally exceeded. Furthermore, in one or more cases, it is not the net asset value that is used as the starting point for determining the bid and offer price, but instead, the most recent stock exchange price. This means that there is no guarantee that the maximum surcharges and discounts advertised in the prospectus are being complied with.
- In one or more cases, it is difficult to find any information about the incorporating of surcharges and discounts. In order to gain a complete picture of the procedure used, the investor must search for the information in various documents (eg, annual report, prospectus, supplementary prospectus, custody and management conditions, giro-based securities transfer system conditions, financial information leaflet, etc.). Part of the reason for this lack of transparency is down to the legislation and regulations. This was taken into account when reviewing these regulations.

## **2. Comparing costs charged to investors with the costs advertised in the prospectus**

- In one or more cases, the costs are not fully or not clearly stated in the prospectus.
- At one or more CIS's, there is a risk that capital tax is erroneously levied on a purchase.
- In one or more cases, the prospectus contains incorrect information on the allocation of capital tax vis-à-vis the investor.
- The costs of a *fund of funds* (a collective investment scheme that invests in other collective investment schemes) are, in one or more cases, insufficiently transparent. As a result, investors are paying accumulating costs without being aware of it.
- In one or more cases, the fees for the distribution channel are paid out of the management fee. In a number of cases, the long-term investor is indirectly subsidising new investors and those pulling out. The current regulations do not forbid this, but it is recommended that the industry makes this practice transparent.

## **3. Pricing and trading with affiliated parties and third parties**

Research in the United States has shown that a number of collective investment schemes has deliberately maintained improper trading practices, thereby enabling third parties and employees of the CIS to benefit from this practice themselves at the expense of the long-term investors. Trading outside stock exchange hours at lucrative prices (*late trading*) and quickly entering and exiting the market in order to arbitrage small price differences at the expense of long-term investors (*market timing*) has led to prosecution of the parties involved and large fines, and to investor compensation schemes. In the Netherlands, the AFM has not discovered any such improper trading practices, in so far as this relates to trading with third parties. However, one or more CIS's have been shown to use *late trading*. Furthermore, in one or more cases there was an undesirable form of price influencing.

- In one or more cases, parties affiliated to the collective investment scheme, such as the liquidity provider, are moving the transaction price away from the net asset value without this being justified by market conditions. This is done in order to achieve the closing price for the relevant trading day that the CIS wants. It is true that this only happens within the bandwidth stated in the prospectus, but it gives a less accurate picture of the current value.
- In one or more cases, it turns out that the liquidity provider has during stock exchange trading hours (and sometimes outside stock exchange hours) traded with the collective investment scheme at 'old' transaction prices, based on an outdated net asset value. The change in the underlying value was such that the liquidity provider benefited.
- Shortcomings in the administrative organisation and/or late adjustment of the net asset value can lead to *late trading* taking place. Apart from the above trading between CIS

and liquidity provider, to date, no cases of *late trading* have been established within the group of CIS's investigated.

- The liquidity provider balances conflicting interests (own interest, investor's interest, CIS's interest). This requires a high level of control, in the form of procedures, work instructions and internal controls to achieve this. In one or more cases, the level of control is too low.

#### **4. Calculating the net asset value**

- In the case of many of the CIS's investigated, shortcomings were established in the process that calculates the (current) net asset value (justification, controls, approving and screening), thereby creating the risk of an incorrect setting of transaction prices, trading with insider knowledge and *market timing*.
- In one or more cases, it has been established that persons involved in the setting of the net asset value can engage in trading too. This enables insider trading to arise. One or more CIS's have taken insufficient measures to prevent this from occurring.
- The calculation of the net asset value is one of the critical key processes of a collective investment scheme. In one or more cases, it appears that the management was not sufficiently involved in this process.

#### **5. Quality of the administrative organisation**

- At many of the CIS's investigated, descriptions of processes or procedures are either outdated, wholly or partly missing, or are incorrect and incomplete. Furthermore, in many cases, they are not fully complied with, or else there is no way of checking whether the procedures have been complied with.
- At many of the CIS's investigated, there are insufficient internal controls on whether rules are being complied with.
- Many of the CIS's investigated have not properly drawn up written agreements made between the collective investment scheme and liquidity provider regarding the maintenance of the market.
- In the pricing process, each separate link in the chain is generally well-informed about the activity that it must carry out itself, but in one or more cases, it has no insight into the activities of the other links in the chain. In one or more cases, the communication between these different parties needs to be improved. In such cases, the management also lacks information on, and knowledge of, essential business processes.

#### **Other issues**

The findings from the investigations raise questions about related subjects, such as the governance of collective investment schemes, the role of the auditor, and the state of affairs in respect of unit-linked products.

#### **Governance**

Currently, good corporate governance is one of the most important issues in all companies throughout the world. In many countries, the legislation is being revised or added to in this area. Among other requirements, the *Act on Supervision of Collective Investment Schemes* (Wtb) sets requirements for collective investment schemes with regard to the expertise and trustworthiness of directors, financial safeguards, business practice and information provision. The new version of the Wtb has increased the number of requirements and tightened them up. A number of these requirements are also dealt with separately in the general guidelines for companies, such as recently formulated by the Corporate Governance Committee ('Tabaksblat' Committee). Collective investment schemes are not governed by this code, even though it is certainly relevant. Important basic principles are that collective investment schemes must act in the interests of its participants, and should discourage any conflict of interests. The AFM's findings reveal that this is not always sufficiently the case, and has reported bottlenecks on issues such as:

- the lack of information that the Board of Director/management company, which means that it/he is insufficiently prepared for the task of assuming responsibility for the investment policy
- the lack of transparency in the relationship with the financial conglomerate of which the CIS is part;
- the giro-based securities transfer system, which often has the legal form of a foundation, often has the same transparency problems like a company with statutory, two-tier status has with shares. Here, too, depositary receipts are issued for the units, so the exercising of the voting rights is not always a matter of course, and
- the lack of transparency in the remuneration scheme for the management company.

### **The role of the auditor**

The findings of the investigation also make it desirable to take a closer look at the roles of the internal auditor and external auditor too. Many findings relate to the organisation and control of the business processes (AO/IC). In a number of cases, the controls carried out by the internal auditor have hardly examined these processes, and have instead concentrated mainly on the annual accounts. The external auditor performs his work on the orders of his client, in this case, the collective investment scheme. In the case of many of the CIS's investigated, these controls are limited to the certifying of the annual accounts. In a number of cases, the external auditor has to involve the internal processes in his audit more explicitly. The legislator can encourage this by specifying in more detail the statutory requirements regarding the AO/IC, which would give both the CIS and the auditor more to go on. We refer in this connection to the external auditor's active duty to report in accordance with the Wtb Act which came into force on 1 December 2003.

### **Unit-linked products**

Unit-linked products, which are life-insurance products where some or all of the premium is invested in collective investment schemes, need to be investigated too. The AFM is of the opinion that at least as much attention should be paid to these products as to the collective investment schemes investigated. Unit-linked products did not form any part of our investigation. It may be, however, that the situation regarding transparency, administrative organisation and internal controls is no more favourable than that currently found in the market for collective investment schemes. The AFM recommends that the providers of the unit-linked products be investigated in the same way as has just been done with collective investment schemes.

### **The follow-up steps**

In respect of all CIS-specific shortcomings where legislation or regulations were infringed, the AFM shall deal directly with the CIS's in question. Where necessary, AFM will use suitable enforcement tools. Note that a number of CIS's have already made improvements.

In addition, the AFM is making an urgent appeal to the sector to take the lead in rectifying the shortcomings that have been discovered. In doing so, the AFM wants to link up with the Cabinet's wishes, of allowing self-regulation where possible and lightening the administrative burden.

In order to achieve this goal, AFM will set up together with the market a 'Committee for Modernising Collective Investment Schemes' (*Commissie Modernisering Beleggingsinstellingen*) headed by an independent chairman. The committee will have to issue an advice to the AFM by the end of 2004. That advice will encompass specific operational recommendations for rectifying the shortcomings found. The recommendations could relate to the role and the responsibilities of the market players, the supervisor and the legislator.

The committee's recommendations will relate to the following issues, particularly:

- the system of surcharges and discounts when buying and selling units

- the transparency of costs charged to investors
- pricing and trading with affiliated third parties
- calculating the net asset value, and
- quality of the administrative organisation.

In addition, the committee will make recommendations on:

- the governance of collective investment schemes
- the role of the auditor in collective investment schemes, and
- the relationship between the Dutch and foreign systems of trading in units.

#### *Amendment of existing legislation*

In addition to addressing CIS-specific and generic shortcomings, the results of the investigation will be taken into account by the Ministry of Finance in its amendment of the Wtb Act. The amendment of the Wtb Act and the Btb Decree is a process that had already been started quite some time before this investigation began. We have consulted with the Ministry of Finance about the implication of our investigation regarding the amendment of the Wtb Act.

#### *Follow-up investigation*

The AFM has only looked at a few issues under this mandate. A number of items that are related to the issues investigated will be investigated by the AFM in the future, possibly in collaboration with other supervisory agencies. These could include:

- the unit-linked products
- the valuation bases used by property funds
- pricing at closed-end funds, and
- transaction costs that CIS's incur when buying and selling investments for their portfolio, and the composition of the investment portfolio.

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## 1 Introduction

### 1.1 The importance of the investigation

The market for collective investment schemes has expanded enormously over the past decade. Total investments in collective investment schemes have quadrupled to about EUR 100 billion<sup>1</sup>. Currently, almost 25% of all Dutch households have funds invested in collective investment schemes. In addition, many households have entrusted their money to collective investment schemes indirectly via so-called *unit-linked* products. Examples include investment-based mortgages, life-insurance policies and pensions. The collective investment schemes carry out the collective management of investors' assets. The responsibility borne by the collective investment schemes is substantial because investors have to be able to place a large measure of trust in the expertise and trustworthiness of the CIS in question. Collective investment schemes are of great importance to the consumer, the financial markets and the economy as a whole.

The supervision of the financial sector was reorganised in 2002. The AFM, the Netherlands Authority for the Financial Markets, the successor to the STE (Securities Board of the Netherlands), is charged with supervising of conduct of business on the part of all financial institutions (banks, collective investment schemes, securities institutions, savings funds and pension funds). The process of supervising of conduct of business focuses on promoting a well-organised and transparent way of doing business on the financial markets, promoting proper and correct relationships between market players, and improving consumer protection. The supervision of conduct of business takes a different approach to that of supervision of prudential behaviour – the latter concentrating on improving financial institutions' solvency and soundness.

A routine investigation in mid-2003, which revealed shortcomings in a collective investment scheme, justified the carrying out of a wider investigation on these issues. The reports being received from the United States in the second half of 2003 regarding improper trading practices at collective investment schemes only increased the urgency of our investigation.

### 1.2 The scope and the limitations of the investigation

The investigation has concentrated on a number of issues that have been investigated at a small number of different-sized providers. A number of collective investment schemes were investigated more closely at each of the providers. In particular, the investigation focused on the collective investment schemes supervised by the AFM, that can issue or redeem units, sometimes at the request of participants. Together, the providers and collective investment schemes investigated form a representative section of the market.

The issues that the AFM investigated were, respectively:

1. Incorporating surcharges and discounts on the purchase and sale of units in collective investment schemes in relation to the information in the prospectus;
2. Comparing costs charged to investors with the costs advertised in the prospectus;
3. Pricing and trading with affiliated parties and third parties;
4. Calculating the net asset value;
5. Quality of the administrative organisation.

It should be noted beforehand that there are two separate stages to the AFM's investigation into the shortcomings. The first stage is this report. The shortcomings that are discussed in it have been submitted to the relevant CIS's where they were discovered. The CIS's were given

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<sup>1</sup> This figure for investments relates solely to the Wtb funds that are monitored by AFM. Related products such as unit-linked products have experienced similarly explosive growth.

the opportunity to submit their response to the AFM. The AFM has incorporated its responses into this report where it deemed it necessary to do so. The second stage relates to the findings for each CIS. These are handled separately from this report, and directly with the relevant collective investment schemes. In most cases, this process has not yet been completed.

The AFM has established different types of shortcomings. In our opinion, one type of shortcoming relates to a clear infringement of legislation and regulations relating to financial supervision. In addition, shortcomings were detected about which the AFM has serious doubts as to whether regulations and legislation were complied with. In this case, various different interpretations of the legislation and regulations are possible. The AFM will, where necessary, deploy suitable enforcement tools for these two types of shortcomings. Finally, there are shortcomings that the AFM characterises as ‘undesirable practices’, but where there is no basis in the legislation or regulations for banning them. This also includes a number of transparency-related issues arising from the typical Dutch method of pricing used on the stock exchange. Here, investors buying or selling are settled at a single price that is arrived at on the stock exchange, and which fluctuates somewhere within the maximum bandwidth set by the CIS around the net asset value. This price includes surcharges and discounts to cover certain one-off costs. In other countries, the net asset value is used as a starting point, on which a fixed surcharge or discount is charged so that participants always know exactly what the costs are and how much they are paying for a unit.

The findings of the investigation are presented in this report in general terms and without specific reference to individual providers or collective investment schemes. The AFM has a duty of confidentiality in respect of all data and information that it receives from individual providers or collective investment schemes. The bases for this are, respectively, Article 31, first paragraph of the *Act on the Supervision of Securities Transactions* (Wte) of 1995, and Article 24, first paragraph of the *Act on the Supervision of Collective Investment Schemes* (Wtb). Article 24, paragraph 5 of this Act provides the basis for publishing the current report, whereby the findings are presented such that the individual companies cannot be identified or deduced.

The shortcomings found have led us to make a number of comments on other issues, such as corporate governance and the role of the external auditor. Unit-linked products have been excluded from this investigation, as they are not covered by the duty to obtain a licence from the AFM.

### **1.3 The content of the chapters**

The subjects investigated will be discussed in the following chapters. They will be preceded by two introductory chapters (2 and 3), which offer some basic information. Each of the five chapters that follow on from them (chapters 4 to 8 inclusive) will deal with one of the issues. A set layout will be used for this, whereby some background information on the subject will be provided first of all, followed by a discussion of the findings, and finally any (further) issues will be dealt with. The subjects investigated are:

- Incorporating surcharges and discounts on the purchase and sale of units in collective investment schemes in relation to the information in the prospectus (chapter 4);
- Comparing costs charged to investors with the costs stated in the prospectus (chapter 5);
- Pricing and trading with affiliated parties and third parties (chapter 6);
- Calculating the net asset value (chapter 7);
- Quality of the administrative organisation (chapter 8).

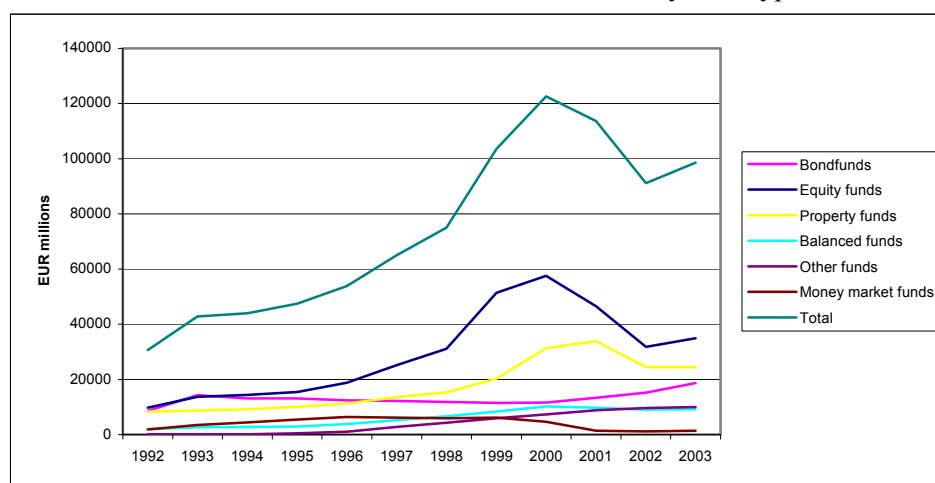
In chapter 9, a number of related issues are reviewed, such as the practice of business management/governance in the collective investment schemes and the role of the external auditor and the relationship with unit-linked products. The report concludes with chapter 10, which discusses the follow-up measures to be taken.

## 2 The market for collective investment schemes

### 2.1 Market developments

Investing in collective investment schemes has been gaining in popularity for some years now. Over the past decade, the value of the funds entrusted has quadrupled. In 2000, total investments peaked at over EUR 120 billion. The decline that subsequently began from the 2000 onwards stemmed from two developments. On the one hand, there was a steep drop in the net deposit of collective investment schemes, and on the other, the price of securities fell, thereby reducing the value of the unit trusts deposited. This market has now recovered again, since the second quarter of 2003. The net deposit is rising again and stock exchange prices are also recovering. As a result, total investments are increasing again. Compared to 2002, total investments have risen 8%. Total investments currently amount to almost EUR 100 billion<sup>2</sup>. The total is made up of investments by private individuals (estimated at EUR 41 billion), insurers (estimate: EUR 37 billion, and this figure excludes unit-linked products), and pension funds (estimate: EUR 22 billion). This figure for total investments of EUR 100 billion relates to the total investments for collective investment schemes established in the Netherlands. The total investments of collective investment schemes in Europe totals EUR 4,255 billion.<sup>3</sup> A substantial proportion of this is invested in France (EUR 891 billion), Luxembourg (EUR 845 billion) and Germany (EUR 751 billion).

Figure 2.1 Balance sheet totals for collective investment schemes by fund type



Source: DNB

### 2.2 Breakdown of investments by source

#### *Investments by private individuals in collective investment schemes*

23% of Dutch households invest directly in collective investment schemes.<sup>4</sup> In addition, a small percentage of households invest in individual shares (10%) and bonds (3%). In other words, ownership of units in collective investment schemes is more widespread than the ownership of individual shares and bonds.

<sup>2</sup> Unless otherwise stated, the source for all figures stated below is the Dutch Central Bank (DNB).

<sup>3</sup> FEFSI Fact Book 2003, p. 14

<sup>4</sup> DNB, Quarterly Report June 2002

The reasons for the popularity of the collective investment schemes for private investors are as follows. Firstly, collective investment schemes accept lower minimum investments than are required for direct investments in individual securities on the stock exchange. A private individual can already invest in a collective investment scheme with just a small sum of money, and does so relatively inexpensively. Secondly, he can spread his risk, no matter how small his investment, because he is participating in a combined diversified investment, thereby helping to reduce his risk. Thirdly, the private investor does not need any specific knowledge about individual shares and categories of investment. After all, the day-to-day management of his investment is contracted out to the collective investment scheme. In other words, investment in collective investment schemes is relatively simple. Fourthly, it offers the private individual a simple way to invest.

*Investments by insurers in collective investment schemes*

Most of the investments in collective investment schemes are made by insurance companies and pension funds. Investments by insurance companies account for an estimated EUR 37 billion, and represent the majority of the indirect investments that private individuals have made on an individual basis. This includes pension policies, annuities, single-premium policies, mortgage constructions with an investment component and suchlike. These products are known as ‘unit-linked’ products. The collective investment scheme’s units are used for these products as an arithmetical unit in a policy. In order to be able to settle any future commitments, the company where the unit-linked product was purchased will use part of the premiums paid to purchase units. In other words, the private individual does not participate directly in the collective investment scheme himself, but instead has an indirect interest in the collective investment scheme through the insurance company.

*Investments by pension funds in collective investment schemes*

At year-end 2003, investments by the pension funds were estimated at EUR 22 billion. This amount is invested in collective investment schemes by means of the collective arrangements made with employee pension schemes. In other words, here too, the private individual is not a direct participant in the collective investment scheme, but has claims on part of the collective assets of his pension fund through the rights that he has built up.

In other words, the importance of investing in collective investment schemes is significantly greater than could be deduced from the numbers for direct investments alone. Despite the fact that indirect investments largely fall outside the scope of this investigation, the possibility cannot be excluded that the situation in this part of the market for collective investment schemes is similar to that for the direct investments, and we recommend that the same issues be investigated for that part of the market too.

### 3 The different components of trading in collective investment schemes

This chapter will discuss the basic structure used to trade in collective investment schemes. This is essential in order to be able to place the investigation findings in their proper perspective.

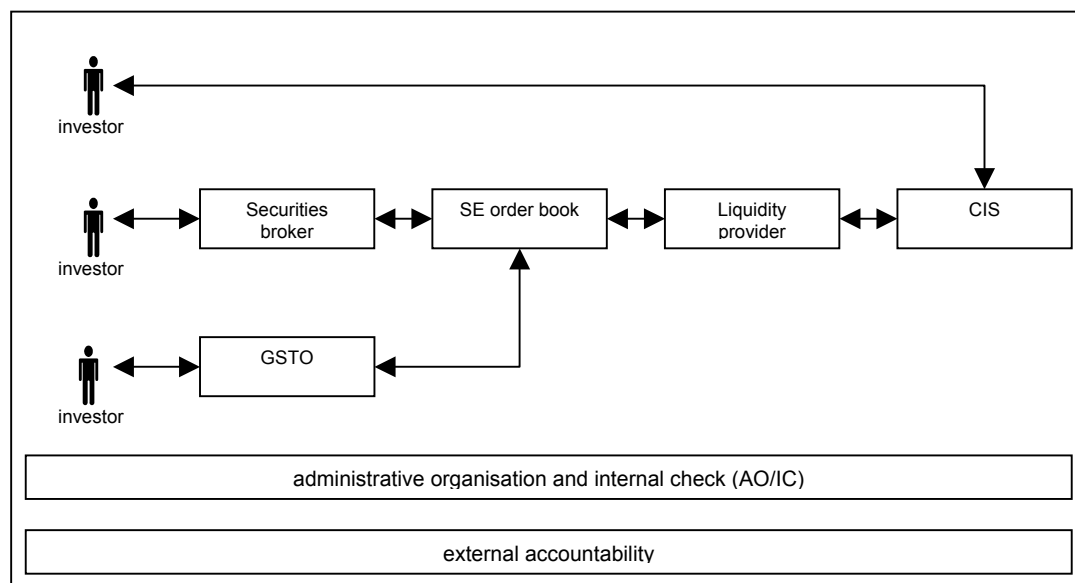
#### 3.1 Terms

*Collective investment scheme* is a collective term for constructions in which investments are made on a collective basis. There are two types of collective investment schemes. The first type is the investment *company*, which is a legal entity usually listed on the stock exchange. Its units are called *shares* and are traded on the stock exchange. The investment company is managed by two or more persons (legal entities). The second type of collective investment scheme is the *unit trust*. Unit trusts are composed of *units*. These are not usually listed on the stock exchange. The unit trust is not a legal entity and has a management company and a custodian. The management company is charged with managing the funds and has two or more directors. The custodian also has at least two directors. One of the custodian's task is to monitor the management company's investment policy.

#### 3.2 A global overview of the components

The structure of the components in the Dutch system is reproduced in simplified form in Fig. 3.1.

Figure 3.1: Global overview of the different parts of the Dutch system



The investor who wishes to invest capital in a collective investment scheme can do this through any one of three trading channels: directly with the collective investment scheme, via a securities broker, or via the giro-based securities transfer office (GSTO). The GSTO is a type of administrative office of the collective investment scheme, which settles the transactions (either by transferring funds, or, in many cases, settling via the Internet), and manages the units.

Leaving aside the investor's direct transactions with the collective investment scheme, the investor's order, or net order, from multiple transactions is then passed on via one of the

above channels to the stock exchange and ends up in the stock exchange's *electronic order book*. The price is automatically added to it by matching supply with demand.

The pricing and the order book on the stock exchange are influenced by the *liquidity provider*. His instructions are to make the stock exchange trading in units in the collective investment scheme more flexible. To do this, he creates liquidity by quoting *bid and offer prices* which he is obliged either to buy or to sell at, if there is insufficient supply and demand, or if no counterparty can be found. He does this by, among other things, on the basis of *bid and offer prices* at which he may buy from, or sell to, the collective investment scheme. The collective investment scheme bases these prices on the unit's net asset value, which equals the value of the investments and liquid funds divided by the number of outstanding units. In other words, when trading units in collective investment schemes, the liquidity provider acts as an intermediary between the investor and the CIS. He often holds a buffer of units himself, and sometimes his role is confined to that of acting as a 'conduit' for transferring units between the investor and the CIS. Note that the liquidity provider for units in collective investment schemes is a typically Dutch phenomenon, arising from the system of continuous trading. Few other countries use liquidity providers, and the trading system is often different there (see Box 1).

When investors deposit their monies, they hand over the management of their assets/investments to the collective investment scheme. Accordingly, the collective investment scheme has the statutory obligation to safeguard the interests of investors, and to draw up procedures and rules in its business operations to achieve this. The administrative organisation consists of the descriptions of processes and work procedures and the resulting information flows. An essential component of this is the system of internal controls (IC) on the information flows. This is why the term 'administrative organisation and internal controls' (AO/IC) is used.

Finally, investors obtain information from the publications that the collective investment schemes are obliged to provide to the general public. On the one hand, this information helps the investor to make his investment decisions. On the other hand, the CIS uses the publications to justify its actions vis-à-vis the investors that have entrusted their monies to the CIS.

#### **Box 1: The Luxembourg System**

The Netherlands has system of trading that employs some rather unusual features. Most other countries use a different system. These differences are described below using Luxembourg as an example. In Luxembourg there is only one time of day when trading may take place. All accumulated orders from the preceding 24 hours are executed then. As trading can only take place once a day, there is a need to use a liquidity provider. In the Netherlands, this is usually possible all the time. Another difference is that in Luxembourg, the net asset value is the price at which investors can trade. A fixed percentage trading fee is charged when buying and also sometimes when selling. Furthermore, this percentage also depends on the distributor that is used. In the Netherlands, a one-off fee is charged on top of the net asset value, which varies depending on supply and demand. The Dutch system is discussed in more detail in chapters 4 and 6 and in Appendix I.

### **3.3 Statutory requirements, supervision and accountability**

The legislator has imposed a number of strict statutory requirements on the collective investment schemes, in order to protect the capital that investors have entrusted to them as much as possible. The most important requirements are:

- Requirements regarding the expertise and trustworthiness of directors;
- Financial safeguarding: the collective investment scheme must have a minimum level of capital and reserves;
- Requirements regarding the management of the business, and
- Requirements regarding the provision of information.

The collective investment scheme has to be able to demonstrate that it is complying with the abovementioned requirements in order for the AFM to grant it a licence. In addition, it must comply with the abovementioned requirements at all times, and is therefore under the AFM's continual supervision. The licensing requirements for collective investment schemes relate to aspects such as, for example, the management of the business. For example, the 'four-eyes principle' must be complied with, which means that the day-to-day management of the collective investment scheme must be entrusted to two people. The administrative organisation of the collective investment scheme must be able to give a complete and accurate account of the composition of, and movements in, the investments. A proper administrative organisation is a necessary prerequisite for the CIS to function properly, and is also essential for the accurate recording of rights of unit holders. The auditor needs it too, and it is also a necessary component for proper supervision. After consulting with sector representatives, the supervisor has distributed circulars describing the way to set up the administrative organisation.

The collective investment scheme is further obliged to provide information to its investors in its prospectus, the financial information leaflet, the annual report and the half-year figures. The prospectus provides information on such practical matters as the CIS's address, as well as on the corporate objective, investment policy, structure of the CIS and the fund's risk profile. Technical issues are also discussed in detail, such as the determination of the net asset value, the settlement of orders, and the costs. The financial information leaflet sets out the product's features. It also includes information on historic and sample returns, which makes clear the risk for the consumer. Finally, in the annual report the CIS accounts for its investment and dividend policies, and for the income and expenditure for the reporting period. The report also contains important changes to the personnel and to the Articles of Association. The annual report is verified by an external auditor.

## **4 Incorporating surcharges and discounts on the purchase and sale of units in collective investment schemes in relation to the information in the prospectus**

### **4.1 Background**

In the Netherlands, in the case of the purchase and sale of units in collective investment schemes, it is usual to charge one-off costs in the form of surcharges and discounts. When buying a unit, a surcharge on the net asset value is included in the price. With sales of units, a discount is included in the price. The maximum percentages of these surcharges and discounts that are charged as costs are advertised in the prospectus. In other words, these costs are charged in addition to the cost for the channel of trade (transaction costs) that the investor uses. The total of the surcharge and the discount for collective investment schemes in the Netherlands together, is a maximum of 4%<sup>5</sup>, whereas the costs for the channel of trade are usually approximately 0.5%.

In practice, the settlement of the surcharges and discounts is carried out in different ways. For instance, one CIS may calculate a particular price for the investor if he is buying (the asked price) and another, lower price if he is selling (the bid price). It may also be that the investors' transactions are settled at a single price for both new investors and investors pulling out of the market. In such cases, the buy and sell orders are then either netted out or 'cancelled out against each other'. This process is called 'netting'. In that case, the price will lie somewhere within the maximum bandwidth set for surcharges and discounts around the net asset value. This means that the trading investor may be better off than if he had to pay the maximum surcharges and discounts on top of the net asset value. The following box clarifies this situation.

Part of the income flows arising from the difference between the surcharge price and the discount price, ends up with the liquidity provider at the stock exchange, and part accrues to the collective investment scheme. The liquidity provider can re-deposit these income flows in the collective investment scheme's funds, or retain them for himself as remuneration for his activities and for the risks on the positions he takes. If the income flows back to the collective investment scheme, this adds to the net asset value of the units, and consequently, to the long-term investor.

The prospectus provides details on the system that the collective investment scheme uses when trading its units and on the mechanism used to determine the price that the investor is charged. Naturally, the investor has to be told which price in relation to the net asset value he will be charged in which situation.

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<sup>5</sup> These percentages apply to collective investment schemes that invest in equities. Those collective investment schemes that invest in the money market or in fixed-interest securities, often charge lower percentage costs.



**Box 2. The systems of surcharge and discount**

Suppose that the net asset value (NAV) of a unit is 100.

**I. Normal surcharge and discount (2 prices)**

If the percentage surcharge and percentage discount that total 4% around the NAV are evenly shared between buying and selling, then a purchase will be settled at price of 102, and a sale at price of 98. In other words, the buying and selling prices differ.

**II. Netting (1 price)**

If the *netting* method is used, then buy and sell orders will be netted out and a single price is arrived at. There are three possible scenarios here:

1. There is a high structural level of net demand, which leads to the price being above the NAV; the most extreme permitted combination, given the bandwidth of 4%, consists of an asked price of 102 with a bid price of 98; when netting the orders, a single price is arrived at that will be at, or close to, the upper limit of the bandwidth of 102. In such situations, therefore, the *new investor* pays approximately the same price for a unit as he would under the system that uses 2 prices. The *investor pulling out of the market* achieves a much higher price: his gain compared to system I is:  $102 - 98 = 4$ . The impact this has on the long-term investor's position is not unequivocal. It depends on whether the monies from the surcharges and discounts flow back into the CIS (and therefore accrue to the benefit of the long-term investor), or whether they are 'creamed off' by the liquidity provider.
2. There is a high structural level of net supply, which leads to the price being below the NAV; the most extreme combination, given the bandwidth of 4%, consists of a bid price of 98 with an asked price of 102; when netting out the orders, a single price is arrived at that will be at, or close to, the lower limit of the bandwidth at 98. The *investor pulling out of the market* receives about the same price as in the system that uses 2 prices. The *new investor* gains considerably: he pays 98 instead of 102 in the system with 2 prices, which means his gain is 4. Again, the impact on the *long-term investor's* position is not unequivocal. It depends on whether the monies from the surcharges and discounts flow back to the CIS (and thus accrue to the benefit of the long-term investor), or whether they are 'creamed off' by the liquidity provider.
3. The net demand and net supply are always close to one another structurally; the bandwidth will move back and forth around the NAV of 100; all combinations of bid and asked prices can occur with a maximum bandwidth of 4; when netting out the orders, a single price is arrived at that is at, or close to, the NAV of 100. This is more profitable for both the *new investor* and the *investor pulling out of the market* than the system of 2 prices that uses the maximum bandwidth: the *new investor* pays 100 instead of 102 and thus saves 2, whereas the *investor pulling out of the market* receives 100 instead of 98 and thus receives 2 more. Once again, the impact on the *long-term investor's* position is not unequivocal. It depends on whether the monies from the surcharges and discounts flow back to the CIS (and thus accrue to the benefit of the long-term investor), or whether they are 'creamed off' by the liquidity provider. What is true, however, is that in the situation where the NAV is charged to the *new investor* and to the *investor pulling out of the market*, no expense surcharge is charged in practice. Should this occur long term with a collective investment scheme, there will hardly be any funds for the liquidity provider to retain or that could be 'recycled' back to the CIS to accrue to the benefit of the long-term investor.

**4.2 Shortcomings**

The prospectus states that the surcharges and discounts will be processed in a certain way. We have discovered that, in practice, this may be effected in a different way, as a result of which the investor is either given the wrong impression or even has his interests damaged:

- In a number of cases, the income that the liquidity provider earns from the system of surcharges and discounts does not flow back to the CIS, even though in one or more cases it may be deduced from the prospectus that it should.
- In many CIS's, it is normal practice that buy and sell orders (usually from the giro-based securities transfer system) are netted out and the orders settled at a single price (*netting*). The collective investment scheme could 'miss out' on income from the surcharge or discount, so long-term investors could be missing out, compared to new investors or those pulling out. In one or more cases, this practice was found to be at odds with the information in the prospectus.
- At many of the investigated CIS's, it was established that the bandwidth set out in the prospectus within which the surcharge and discount may fluctuate, was occasionally exceeded. Furthermore, in one or more cases, it is not the net asset value that is used as the starting point for determining the bid and offer price, but instead, the most recent stock exchange price. This means that there is no guarantee that the maximum surcharges and discounts advertised in the prospectus are being complied with.
- In one or more cases, it is difficult to find any information about the incorporating of surcharges and discounts. In order to gain a complete picture of the procedure used, the investor must search for the information in various documents (eg, annual report, prospectus, supplementary prospectus, custody and management conditions, giro-based securities transfer system conditions, financial information leaflet, etc.). Part of the reason for this lack of transparency is down to the legislation and regulations. This was taken into account when reviewing these regulations.

The problem of lack of transparency that occurs in some cases, is typical of the Dutch situation. In many other countries, this cost surcharge does not depend on the outcome of the pricing mechanism on the stock exchange (see system I in box 1). Instead, the surcharge and discount are fixed percentages that are advertised in the prospectus. This means that the investor knows what the costs are and how much he is paying for a unit.

## 5 Comparing costs charged to investors with the costs advertised in the prospectus

### 5.1 Background

Costs that the collective investment schemes charge can significantly affect the return that the investor ultimately receives. The costs charged to an investor can be divided into one-off and recurring costs. The one-off costs are the costs that a new investor pays when he enters the market, or that an investor pays when he pulls out of the market (ie, sells off). These costs are charged to him the moment he trades. The recurring costs relate to annually recurring charges. These costs are not charged directly to the investor; instead, they are deducted from the managed funds.

Table 5.1 shows a breakdown of the recurring and one-off costs according to type of cost. These costs can differ greatly between different types of collective investment scheme. This is why the table below only gives an indication of the actual costs charged. Most collective investment schemes' costs vary between the margins given below, but there are exceptions. The total one-off costs usually lie between 1.3% and 8%.

Table 5.1 Total recurring costs usually lie between 1.3% and 8%

Categories	Type of cost	Size
One-off costs	Surcharge and discount (poss. including capital tax of 0.55%)	1% - 4%
	Buying and selling costs	0.3 - 0.5%
Recurring costs	Management fee <sup>6</sup>	0.5%- 3%
	Performance fee (remuneration tied to the return and/or size of the collective investment scheme)	0.025%-3%
	Custody fee to own bank or broker	0 - 0.5%
	Other costs, incl. auditor's fee, supervisory fee, custodian's custody fee and the administration costs	0.02%-0.5%
	Transaction costs	0.3% <sup>7</sup> -1%

Source: Annual reports, prospectuses and financial information leaflets of various collective investment schemes.

In recent years, the recurring costs have continually risen (see Fig. 5.1). This may be deduced from the *total cost ratio* (TCR). The *total cost ratio* is calculated by dividing the total costs by the average value of the collective investment scheme's portfolio during a given period<sup>8</sup>. 'Total costs' is defined as all costs (excluding the transaction costs that the CIS charges for buying selling for the underlying investment portfolio) charged to the result and to the capital and reserves during the reporting period. This ratio relates to the costs that are passed on to

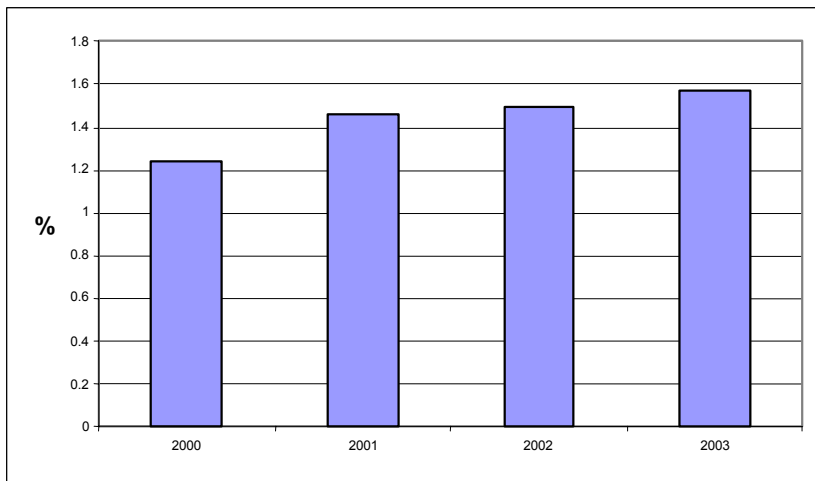
<sup>6</sup> It is impossible to state unequivocally which costs are paid from the management fee. For instance, it may be that a separate intermediary's fee is included.

<sup>7</sup> Average transaction costs for collective investment schemes that invest exclusively in shares.

<sup>8</sup> This relates to the value of the collective investment scheme's assets and not to the net asset value of a unit as discussed in chapter 3.

long-term investors. The costs for entering and exiting the market, that are covered by the surcharges and discounts, have not been taken into account in this analysis.

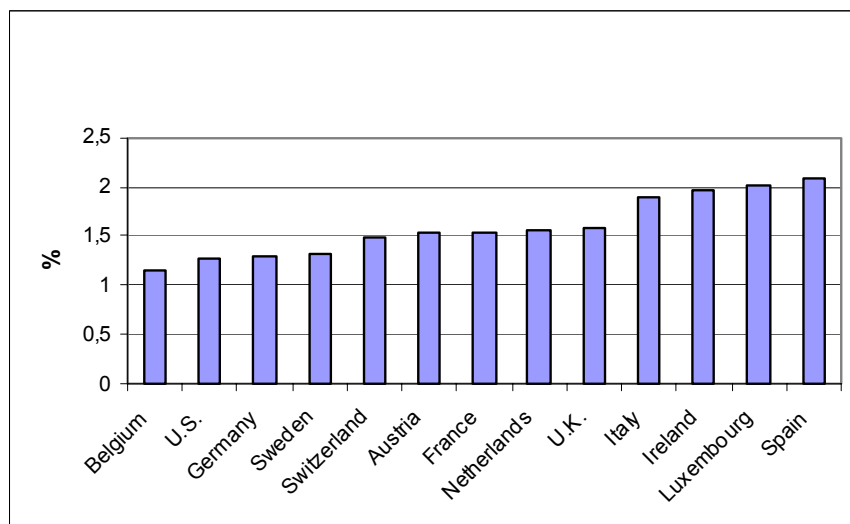
Figure 5.1: *Total Cost Ratio* for equity funds



Source: Standard & Poors

The increase in the TCR can be looked at in two ways. On the one hand, costs (for marketing work, etc.) have increased. On the other hand, the fall in the level of managed funds (due to falling prices on stock exchanges and the fall in the net deposit) has led to a rise in the *total cost ratio*. In recent years, management fees charged by Dutch CIS's have risen to levels that are higher than are commonly found abroad (see Fig. 5.2).

Figure 5.2 Comparison of the *total cost ratio* in the Netherlands with other European countries and the US in 2001

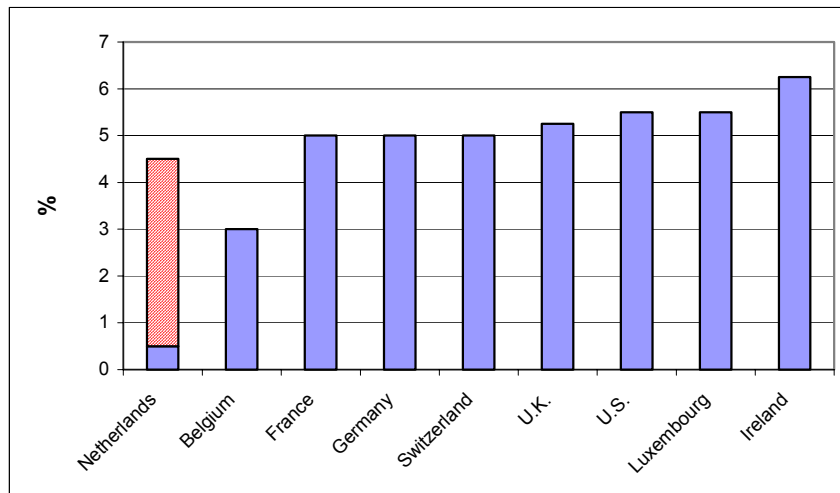


Source: Fitzrovia, 2002; Standard & Poors, 2002; ICI, 2002

Relatively speaking, in the Netherlands, the buying costs of a collective investment scheme are very low (see Fig. 5.3); in general, the buying costs are about 0.5%. In other countries, collective investment schemes' buying costs are higher, usually around 5%. In addition to the buying costs, in many cases selling costs are charged too in the Netherlands, which are also

generally 0.5%. In other countries, it is customary not to charge selling costs. In principle, therefore, you could say that buying and selling costs in the Netherlands are relatively inexpensive. However, in the Netherlands, a surcharge and discount (not charged abroad) have to be added to the relatively low costs. If this surcharge and discount is added to the buying and selling costs, the total costs for buying or selling in the Netherlands amounts to 3% to 4.5%. When you compare these percentages with the 5% charged abroad, the Netherlands may be regarded as more or less in line with other countries.

Figure 5.3 Comparison of buying and selling costs in the Netherlands and the US and a number of European countries



Source: Morningstar 2004

### Box 3. Capital tax

In accordance with the Legal Transactions (Taxation) Act of 1972, investment companies and unit trusts are obliged to pay capital tax on the issue of new units. This tax is charged at a rate of 0.55%. It may be deduced from case law that collective investment schemes do *not* have to pay any capital tax on the sale of previously acquired units. This relates to the temporary redemption of units. In the event of renewed demand, these securities need to be reissued. As yet, there is no time limit on this. This means that the relevant CIS's should carefully administer the redeemed and issued certificates, in order to ensure that capital tax is not paid erroneously.

### Box 4. A *fund of funds*

A *fund of funds* - or *multimanager fund* – does not invest in individual securities, but instead buys units in other collective investment schemes.

The aim of this is to increase accessibility to certain categories of investment. In this way, private investors can, by means of a *fund of funds*, buy collective investment schemes that otherwise would almost exclusively be sold to professionals. An examples of such is the *private equity* or *hedge funds*. Another benefit of the *funds of funds* is that it enables a greater spreading of risk.

Investing in *funds of funds* often costs more, due to the underlying stacking of collective investment schemes. Furthermore, investing in *funds of funds* can lead to less transparency, because it is sometimes not clear to the investor what the underlying collective investment schemes are investing in.

## 5.2 Shortcomings

Collective investment schemes' costs are charged to investors in very different ways, and can greatly affect returns. Collective investment schemes have not been as thorough in their justification or as transparent as they should be:

- In one or more cases, the costs are not fully or not clearly stated in the prospectus.
- At one or more CIS's, there is a risk that capital tax is erroneously levied on a purchase.
- In one or more cases, the prospectus contains incorrect information on the allocation of capital tax vis-à-vis the investor.
- The costs of a *fund of funds* (a collective investment scheme that invests in other collective investment schemes) are, in one or more cases, insufficiently transparent. As a result, investors are paying accumulating costs without being aware of it.
- In one or more cases, the fees for the distribution channel are paid out of the management fee. In a number of cases, the long-term investor is indirectly subsidising new investors and those pulling out. The current regulations do not forbid this, but it is recommended that the industry makes this practice transparent.

Note, by the way, that some of these problems will be rectified, thanks to new regulations regarding the presentation of costs in the annual report. Accordingly, the collective investment schemes will be obliged to show all costs together. In this way, the investor will gain a better understanding of what his costs are.

## 6 Pricing and trading with affiliated parties and third parties

### 6.1 Background

In the Netherlands, units in quoted collective investment schemes are traded via the trading systems on the Amsterdam stock exchange (see Appendix I). However, the pricing process is considerably more complex than it is for ordinary shares. In the first place, the surcharges and discounts around the net asset value include certain costs for the investor (see chapters 4 and 5). On this basis, the collective investment scheme tells the liquidity provider what the bandwidth is to be. He in turn sets the bid and asked price on the basis of the net demand/supply from any giro-based securities transfer office, his own position and the price movements on the stock exchanges and foreign currency markets that affect the net asset value. The opening price of the day will be arrived at by matching supply and demand in the stock exchange's electronic order book. This price is the same for all investors who have submitted buy and sell orders that have no restrictions on their execution. Normally, all transactions made via the giro-based securities transfer office are settled at this price.

Investors can still trade in listed units in collective investment schemes after the opening price has been arrived at. During the stock exchange's trading hours, the liquidity provider provides a bid and asked price at which he will buy from, or, respectively, sell to, investors, adding liquidity to the market. These prices change under the influence of supply and demand, his own position and the development of the value of the collective investment scheme's underlying securities portfolio.

The liquidity provider can actively guide the price. One of his tasks is to keep the price within the maximum bandwidth set by the collective investment scheme. He can cushion major price fluctuations and act as a buffer for the collective investment scheme. He can do this by using his own stock of units. However, guiding the price by trading in his own position enables him to influence the result earned on his own position at the same time. This is a complex situation. A factor that further complicates matters is his relationship with the collective investment scheme. The liquidity provider receives information from the collective investment scheme about the bandwidth around the net asset value, and can carry out transactions directly with the collective investment scheme. Both these factors affect the liquidity provider's own position and, consequently, indirectly affect his result. Sometimes the liquidity provider only acts as an agent for the collective investment scheme and does not trade for his own account (no buffer function, just acts as a conduit). In that case, all buy and sell orders end up at the CIS, who issues (in the case of purchases) and redeems (in the case of sales) units.

### 6.2 Shortcomings

The Dutch trading system is more complex than in other countries, and has many players who can influence the pricing. With regard to *late trading*, shortcomings have been found at one or more financial institutions (unlike the situation in the United States, where this was found on a large scale with *third parties*). In one or more cases, an undesirable form of price influencing was also found.

- In one or more cases, parties affiliated to the collective investment scheme, such as the liquidity provider, are moving the transaction price away from the net asset value without this being justified by market conditions. This is done in order to achieve the closing price for the relevant trading day that the CIS wants. It is true that this only happens within the bandwidth stated in the prospectus, but it gives a less accurate picture of the current value.

- In one or more cases, it turns out that the liquidity provider has during stock exchange trading hours (and sometimes outside stock exchange hours) traded with the collective investment scheme at 'old' transaction prices, based on an outdated net asset value. The change in the underlying value was such that the liquidity provider benefited.
- Shortcomings in the administrative organisation and/or late adjustment of the net asset value can lead to *late trading* taking place. Apart from the above trading between CIS and liquidity provider, to date, no cases of *late trading* have been established within the group of CIS's investigated.
- The liquidity provider balances conflicting interests (own interest, investor's interest, CIS's interest). This requires a high level of control, in the form of procedures, work instructions and internal controls to achieve this. In one or more cases, the level of control is too low.

The Dutch system whereby trading in units is permitted continuously throughout the day, leads to complicated situations. A unit has a stock exchange price and a net asset value, both of which can change during the day. This does not have to happen simultaneously. The market does not know the net asset value, as this is usually not disclosed. In principle, it is only the collective investment scheme that knows this, but it does tell the liquidity provider the bandwidth based on this net asset value, from which he can work out what the approximate net asset value is. Knowing what the net asset value is, and/or being able to guide the price, could be a lucrative position to be in, and one that is at the expense of the other market players. In order to manage this risk, it is critically important that strict agreements are made and kept to, and that there is a proper administrative organisation and system of internal controls in place.



## 7 Calculating the net asset value

### 7.1 Background

The value of a unit in the collective investment scheme is based on the net asset value (NAV). The term ‘NAV’ simply refers to the collective investment scheme’s capital and reserves, the level of which is mainly determined by the value of all underlying investments. The NAV used here is expressed as the capital and reserves divided by the number of outstanding units. The NAV is important because it indicates the actual true price of a unit in a collective investment scheme.

The calculation of the net asset value is complicated, because a collective investment scheme’s portfolio may contain various investments, each of which may have a different value appreciation. Those portfolios whose securities are very diversified geographical spread will be affected both by price movements of the individual securities and by exchange-rate movements. Time zone difference may mean that when calculating the NAV in the Netherlands, that you have to rely on closing prices on the stock exchanges in the Far East or America, even though the exchange rates may still change. With some securities (such as quoted shares) the market value is available at almost any time of the day or night. However, for other investments (such as unquoted companies or *hedge funds*), a market value is only announced from time to time. All these factors create uncertainty when calculating the NAV, which entails that you have to make estimates (ie, to determine the *fair value*). In addition, other outstanding obligations and income of the CIS have to be included in the calculation. Finally, the ever-changing balance of outstanding and redeemed shares and the resulting adjustments in the underlying portfolio also have an affect.

The applicable legislation and regulations stipulate that the administrative organisation and internal controls of the collective investment scheme must have such procedures in place that they can carry out these calculations in such a way that “a true and fair picture of the size and composition of the assets is given”. However, the complexity of the calculations results in errors being made in the published net asset value (and also, therefore, in the pricing based on this net asset value). These errors naturally have to be corrected. Accordingly, the administrative organisation and internal controls of a collective investment scheme should also employ a fixed procedure for correcting errors, in order to safeguard the interests of both long-term investors as well as new investors or investors pulling out of the market.

The net asset value must be calculated by the collective investment schemes at least once a day. Some CIS’s publish a daily figure, whilst others publish it much less frequently. In many other countries, it is common practice for the NAV to be announced daily, as in many cases the buying and selling prices for participants are derived directly from it, through the fixed surcharge and discount.

In the Netherlands, an investor will almost never know the precise relationship between the price that he paid for a transaction on the stock exchange and the NAV at that moment. The price for the transaction can be both higher and lower, as it can fluctuate within a bandwidth of a few per cent around the NAV. Traders who are aware of the current NAV, or can accurately estimate it, can profit from this, because they can choose an opportune moment to effect their transactions.

### 7.2 Shortcomings

The net asset value is the key figure when it comes to pricing. This is why it is essential that the net asset value is calculated correctly. Under the Dutch system, investors can carry out transactions in the collective investment schemes throughout the day (see Appendix I), and

the net asset value is not continually published, something which can give rise to the risk of insider trading and late trading. This risk must be completely controlled, but in practice this has turned out to not always be the case:

- In the case of many of the CIS's investigated, shortcomings were established in the process that calculates the (current) net asset value (justification, controls, approving and screening), thereby creating the risk of an incorrect setting of transaction prices, trading with insider knowledge and *market timing*.
- In one or more cases, it has been established that persons involved in the setting of the net asset value can engage in trading too. This enables insider trading to arise. One or more CIS's have taken insufficient measures to prevent this from occurring.
- The calculation of the net asset value is one of the critical key processes of a collective investment scheme. In one or more cases, it appears that the management was not sufficiently involved in this process.

The sensitivity of information about the net asset value is a problem that is inherent in the Dutch system. Continuous tradability entails that knowledge about the net asset value can be profitable, but at the expense of the other market players. In order to manage this risk, strict agreements and a proper administrative organisation and internal controls are essential. This issue will be looked at more closely in the next chapter.

## 8 Quality of the administrative organisation

### 8.1 Background

To a large extent, it is the quality of the administrative organisation (AO) that determines how well the CIS functions. The laying down of procedures for the management of the business and acting in accordance with those procedures is critically important when it comes to determining the rights and obligations of the CIS towards the investors, and to providing accurate, timely and comprehensive information to investors. Furthermore, it is vital to have a properly functioning AO when it comes to accurately recording rights of unit holders and is in the interests of a properly conducted supervision.

Procedures for internal controls (IC) must uncover incidents such as errors or fraud at an early stage, and thereby act as an internal representative of the investor's interests. In fact, the system of internal controls can be strengthened from outside the CIS itself, by having more extensive controls carried out by the internal accounting department, which is part of the group that the CIS belongs to. In doing so, the controls could be further expanded by giving the external auditor a greater role and, for example, by setting up a supervisory board to monitor the CIS. The AO and the IC are two key ways of safeguarding the interests of investors in the CIS.

### 8.2 Shortcomings

The rules and procedures of the administrative organisation are of crucial importance when it comes to controlling and checking all the processes used within a collective investment scheme; they must in this way safeguard the interests of the participants and ensure that AFM can properly supervise the CIS. AFM has uncovered a number of shortcomings:

- At many of the CIS's investigated, descriptions of processes or procedures are either outdated, wholly or partly missing, or are incorrect and incomplete. Furthermore, in many cases, they are not fully complied with, or else there is no way of checking whether the procedures have been complied with.
- At many of the CIS's investigated, there are insufficient internal controls on whether rules are being complied with.
- Many of the CIS's investigated have not properly drawn up written agreements made between the collective investment scheme and liquidity provider regarding the maintenance of the market.
- In the pricing process, each separate link in the chain is generally well-informed about the activity that it must carry out itself, but in one or more cases, it has no insight into the activities of the other links in the chain. In one or more cases, the communication between these different parties needs to be improved. In such cases, the management also lacks information on, and knowledge of, essential business processes.

The shortcomings in the administrative processes at CIS's have raised questions about the role of the auditor and the involvement of the board (the governance). These will be looked into more closely in the next chapter.

## 9 Other issues

The findings from the investigations raise questions on other related issues, such as the governance of CIS's, the role of the auditor, and the situation with regard to unit-linked products.

### 9.1 Governance

Currently, good corporate governance is one of the most important issues facing all companies throughout the world. In many countries, the legislation for this is being revised or added to. Among other requirements, the *Act on the Supervision of Collective Investment Schemes* (Wtb) sets requirements for collective investment schemes with regard to the expertise and trustworthiness of directors, financial safeguards, business practice and information provision. The new version of the *Act on the Supervision of Collective Investment Schemes* (Wtb) has increased the number of requirements and tightened them up. A number of these requirements are also dealt with separately in the general guidelines for companies, such as recently formulated by the Corporate Governance Committee ('Tabaksblat' Committee). Collective investment schemes are not governed by this code, even though it is certainly relevant. Important basic principles here are that collective investment schemes must act in the interests of its participants, and should discourage any conflict of interests.

The AFM has reported bottlenecks on corporate governance issues such as:

1. The lack of information that the manager has, which means that he is inadequately prepared for the task of taking responsibility for the investment policy.
2. Lack of transparency in the relationship with the financial conglomerate that the CIS is part of.
3. Lack of transparency in the remuneration scheme for the manager.
4. The giro-based securities transfer office, which often has the legal form of a foundation, often has the same transparency problems that a company with statutory two-tier status has with shares. Here, too, depositary receipts are issued for the units, so the exercising of the voting rights is not always self-evident.

### 9.2 The role of the auditor

The findings of the investigation also make it desirable to take a closer look at the roles of the internal auditor and external auditor too. Many findings relate to the organisation and control of the business processes (AO/IC). In a number of cases, the controls carried out by the internal auditor have hardly examined these processes, and have instead concentrated mainly on the annual accounts. The external auditor performs his work on the orders of his client, in this case, the CIS. In the case of many of the CIS's investigated, these controls are limited to the certifying of the annual accounts. In a number of cases, the external auditor has to involve the internal processes in his audit more explicitly. The legislator can encourage this by specifying in more detail the statutory requirements regarding the AO/IC, which would give both the CIS and the auditor more to go on. We refer in this connection to the external auditor's active duty to report in accordance with the *Act on the Supervision of Collective Investment Schemes* (Wtb) which came into force on 1 December 2003.

### 9.3 Unit-linked products

Unit-linked products, which are life-insurance products where some or all of the premium is invested in collective investment schemes, need to be investigated too. The AFM is of the

opinion that at least as much attention should be paid to these products as to the collective investment schemes investigated. Unit-linked products did not form any part of our investigation. It may be, however, that the situation regarding transparency, administrative organisation and internal controls is no more favourable than that currently found in the market for collective investment schemes. The AFM recommends that the providers of the unit-linked products be investigated in the same way as has just been done with collective investment schemes.

## 10 Follow-up measures

As a result of the investigation's findings, the AFM is to implement follow-up measures. These follow-up measures include dealing with CIS's' shortcomings, the setting up of a 'committee of wise men', advising the Ministry of Finance about amendments to existing legislation, and organising follow-up investigations.

### *Dealing with CIS-specific and general shortcomings*

This general report has been written as a result of shortcomings found during investigations into a number of providers of CIS's. In the near future, the AFM is to tackle the shortcomings found at individual CIS's that infringed legislation or regulations. In doing so, the AFM will deploy suitable enforcement tools.

In addition, the AFM is making an urgent appeal to the sector to take the lead in rectifying the shortcomings that have been discovered. In doing so, the AFM wants to link up with the Cabinet's wishes, of allowing self-regulation where possible and lightening the administrative burden.

### *Committee for Modernising Collective Investment Schemes*

In order to achieve this goal, the AFM will set up a 'Committee for Modernising Collective Investment Schemes' (*Commissie Moderniserende Beleggingsinstellingen*) headed by an independent chairman. The committee will have to issue an advice to the AFM by the end of 2004. That advice will encompass specific operational recommendations for rectifying the shortcomings found. The recommendations could relate to the role and the responsibilities of the market players, the supervisor and the legislator.

The committee's recommendations will relate to the following issues, particularly:

- the system of surcharges and discounts when buying and selling units
- the transparency of costs charged to investors
- pricing and trading with affiliated third parties
- calculating the net asset value, and
- quality of the administrative organisation.

In addition, the committee will make recommendations on:

- the governance of collective investment schemes
- the role of the auditor in collective investment schemes
- the relationship between the Dutch and foreign systems of trading in units

### *Amendment of existing legislation*

In addition to addressing CIS-specific and generic shortcomings, the results of the investigation will be taken into account by the Ministry of Finance in its amendment of the Wtb Act. The amendment of the *Act on the Supervision of Collective Investment Schemes* (Wtb) and the *Collective Investment Schemes (Supervision) Decree* (Btb) of 1990 is a process that had already been started quite some time before this investigation began. We have consulted with the Ministry of Finance about the implication of our investigation regarding the amendment of the Wtb Act.

### *Follow-up investigation*

The AFM has only examined a few issues under this mandate. A number of items that are related to the issues investigated will be investigated by the AFM in the future, possibly in collaboration with other supervisory agencies. These could include:

- the unit-linked products
- the valuation bases used by property funds
- pricing at closed-end funds, and
- transaction costs that CIS's incur when buying and selling investments for their portfolio
- the composition of the investment portfolio

## Appendix I

### Trading systems on the Dutch stock exchange

All units in quoted CIS's are traded in the electronic order book of the Amsterdam Stock Exchange (Euronext NV). Euronext uses the following two trading systems:

#### 1. The continuous trading system

The mechanism that the continuous trading system uses works as follows: when an order is received, the electronic order book is examined to see if it can be carried out. If it can, it is executed immediately. If it cannot, the order remains in the order book until it can be carried out.

7.00 - 9.30 a.m.	The order book is opened, orders are entered, the indicative auction price is calculated and announced
9.30 a.m.	Proceedings commence with an auction The opening price is arrived at
	Followed by: continuous trading
17.25 p.m.	End of continuous trading Entering of orders ( <i>book building</i> ) commences for the closing auction, indicative price, no orders executed
17.30 p.m.	Closing auction; closing price arrived at
17.30-17.40 p.m.	Trading at closing price
17.40 p.m.	End of trading

#### 2. The auction trading system for less liquid stocks (double fixing trading system)

This auction mechanism is used to arrive at a price at a certain set time, whereby all available buy and sell orders are executed (in so far as they qualify for execution, based on their pricing conditions, as some orders have a price limit and no counterparty can be found at that price).

7.00 – 10.30 a.m.	The order book is opened, orders are entered, the indicative auction price is calculated and announced
10.30 a.m.	First auction of the day; transactions are settled once auction price has been set
10.30-11.00 a.m.	Trading can be executed at the auction price arrived at ( <i>trading at last</i> )
11.00 a.m. - 16.30 p.m.	End of the trading period; orders are again collected and a new indicative price calculated; trading can be carried out that bypasses the order book
16.30 p.m.	Second auction round, identical to the first
16.30-17.00 p.m.	Trading can be executed at the auction price arrived at ( <i>trading at last</i> )
17.00 p.m.	End of trading at the auction price. Entering of orders ( <i>book building</i> ) commences, indicative price calculated and announced, no orders executed, trading can be carried out that bypasses the order book
17.40 p.m.	End of trading