



**SECURITIES &  
INVESTMENT  
INSTITUTE**

**DECEMBER 2008**

**ADVANCED INVESTMENT SCHEMES ADMINISTRATION**

**MARK SCHEME**

Section A contains 10 short answer questions each carrying two marks. In order to obtain maximum marks in each question candidates should provide two clear and relevant sentences appropriate to the question.

Answer ALL questions in this section

- 1 Compare the role of *fund management* with that of *investment management*. (2 marks)
  - *Investment management is the function of constructing and managing the fund's underlying portfolio of assets.*
  - *This should not be confused with 'fund management', which is a broader business altogether. The fund manager undertakes a number of business activities, including investment management and is usually established and operated as a business itself.*
  - *Within Fund Management each activity is carried out by its own specialist departments. Fund managers can be characterised as intermediaries between the owners of wealth – the suppliers of capital - and the businesses that require investment – the users of capital.*
  - *Investment is a two-way transaction between those who have surplus wealth, or capital, and those who need financial support in their business endeavours.*
  
- 2 Outline the key characteristics of a *fund supermarket*. (2 marks)
  - *Generally supermarkets do not provide advice but rather an administration service.*
  - *A supermarket may, for example, offer a choice from 700 funds selected from a range of fund managers to enable an investor or his/her adviser to make a single telephone call to a supermarket.*
  - *Makes it easy to invest in any of these funds and to switch between funds if investment objectives change or better performance is sought.*
  
- 3 Describe TWO benefits of investing through an intermediary. (2 marks)
  - *Enhanced allocations and/or reduced charges – Intermediaries have been successful in negotiating discounts or higher initial commissions with fund managers, passing on some or all of these benefits to the investor*
  - *Intermediaries provide investment advice to clients and will take time to understand the investor's needs, objectives and appetite for risk*
  - *Reduced time spent on administration and distribution of funds by the investor*
  - *Some intermediaries wrap together different types of investment such as funds, life products and pensions so that the investor has a single point of contact for their investment requirements*

4 Explain TWO prominent developments for pension schemes that have occurred within the last 10 years. (2 marks)

- *The establishment of The Pensions Regulator (TPR) to oversee the industry following the Pensions Act 2004 and to lay down standards for pension trustees, as well as providing assistance in the forms of toolkits and elearning*
- *The recognition that many of even our major companies' defined benefit pension schemes have a shortfall between their schemes' actuarially assessed liabilities and the projected value of assets held to meet them. This has led not only to many millions of pounds of extra employers' contributions but also to the closing of schemes to new entrants and their replacement with defined contribution or money purchase schemes*

5 Briefly discuss how a manager can develop a *matching asset model* for a pension fund. (2 marks)

- *The investment manager of a pension fund will need to ensure the fund has sufficient liquid assets to meet claims when they arise, In practice, the manager will know the scheme's liability profile and, in broad terms, will develop a matching asset allocation model.*
- *and from year to year will adjust the fund's risk profile, to ensure an appropriate balance of holdings, principally between equity shares and corporate and government bonds, the latter to meet short-term liabilities, the former to achieve growth to cover longer term claims.*
- *Low risk, income-earning assets must be held to support the pensions in payment and the entitlements of those nearing retirement, while equities can be held for growth in respect of the scheme's younger members.*

6 Explain TWO pitfalls faced by companies which opt for delegation/outsourcing of certain operations. (2 marks)

- *Poor client-supplier 'fit'. A successful arrangement is more than volume processing; it needs shared values, cultures and business philosophies;*
- *Lack of flexibility in contractual arrangements. Contracts that are binding for far too long – 'carved in stone' – with terms that looked reasonable three years ago but are not suitable today or may not be suitable in three years time;*
- *Confidentiality and conflicts. Keeping ideas or processes secret from competitors who may be using the same third party can be a concern, and disputes can arise over conflicting claims of ownership of data, systems and processes.*
- *Conflicting priorities. While each principal firm is just one of several clients for the third party agent, each expects its business to receive unstinting and high priority attention, which may not be an economic proposition for the agent firm.*
- *Cannot outsource regulatory responsibility. Although the FSA requires firms to carry out due diligence before appointing any agent, regulatory responsibility remains with the firm.*

7 Outline TWO of the entries which MUST be kept by the registrar for unit trusts/shares ownership. (2 marks)

- *The name and address of each holder – up to four names may be registered per holding as with property generally English law and as specified under COLL and the OEIC Regulations 2001; and should include the date each unit/shareholder's name was entered on the register;*
- *Number of units/shares (including fractions of units or smaller denomination shares, where applicable) of each type held by each holder. This should also reflect any different denominations of unit/share issued, and must be updated regularly, normally daily; Any units/shares held in the Manager's Box must also be recorded.*
- *The number of units/shares of each type in issue and represented by bearer certificates and the numbers of those certificates.*
- *Dates of change of unit/shareholdings; and Date(s) of cessation of the unit/shareholding.*

8 Briefly explain how a SICAV differs from an OEIC. (2 marks)

- *A SICAV is a legal entity, with a Board of Directors to oversee the fund; whereas a UK OEIC commonly has only a single Director, Authorised Corporate Director.*
- *Individual shareholder receives voting rights and has the right to attend the (AGMs). UK OEICs have the option of dispensing with AGMs, and most are exercising this option.*
- *Shares in SICAVs are bought and sold at prices based on the fund's current net asset value. Although some issue capitalisation and distribution shares, the equivalent of accumulation and income shares that may be offered in a UK collective investment scheme. They will also frequently offer currency shares, and shares denominated in Euros, etc.*
- *SICAVs only use single pricing. OEICs have the option of being single or dual priced.*

9 Detail TWO circumstances which permit the non-issuance of a certificate to an investor by a Unit Trust. (2 marks)

- *if, according to the terms of the trust deed (or following the giving of appropriate notice, usually three months) the manager and trustee are relieved from the duty to issue certificates;*
- *if the holder has requested, and the trustee has agreed, that no certificates be issued to him;*
- *if the units are purchased under a savings plan scheme or a withdrawal scheme (where units are redeemed at regular intervals); until the registration details have been obtained.*

10 What is an *In Specie* settlement? Give a reason why it might occur. (2 marks)

- *Occasionally, an investor may wish to settle his investment by transferring investments (rather than cash) to the scheme. This is termed an “In Specie” transfer. (1 mark)*
- *Under the regulations, the trustee/depositary may issue units/shares in exchange for assets other than money subject to the following:*
  - *Any SDRT liability on issue of the units/shares is satisfied (1 mark)*
  - *Existing and potential unit/shareholders are unlikely to be materially prejudiced by the assets acquired, ie, the assets are consistent with the objectives of the scheme. (1 mark)*

**Continued overleaf**

## Answer TWO questions in this section

11 A new employee has asked you what Stamp Duty Reserve Tax (SDRT) is, as the book she is reading (dated October 1998) does not mention it.

a) Explain to her what it is, and when it arises. (6 marks)

- *Stamp duty is collected on the transfer of title to property.*
- *SDRT is a charge that applies to agreements for the sale of property if the transfer of ownership does not require a stock transfer form or other stampable instrument. It does however only apply to the transfer of chargeable securities including stocks, shares and similar equity rights.*
- *The current rate of SDRT is 0.5% of the value of the securities sold.*

*Investment Transactions within the Fund*

- *CISs are normally subject to stamp duty on transfers when purchasing UK registered stocks and securities, except, for example, gilts and loan stocks.*
- *An SDRT regime was introduced with effect from 6 February 2000 for transactions in the units/shares of CISs.*

*'In Specie' Cancellation (Redemption) of Units/Shares*

- *If underlying securities are transferred in specie it is not part of a winding-up of the fund, stamp duty of 0.5% of the value of the securities transferred should be payable.*

*Fund Reconstructions and Mergers*

- *In a proposed merger of two or more CISs, liability to SDRT must be considered if there will be a:*
- *Conveyance on sale (ie, transfer) of the units/shares in one or both of the schemes;*
- *Transfer of the underlying property held by the schemes.*

*Transfer of Units/Shares by Shareholders*

- *Securities can be transferred by unit/shareholders using a common stock transfer form; such transfers prior to 6 February 2000 were liable to stamp duty, transfers for value of units or shares in CIS are subject to SDRT.*

- b) Explain the approaches Her Majesty's Revenue & Customs (HMRC) accepts in relation to SDRT (4marks)

*HMRC does not lay down a rule for averaging these values. (1 mark) Any of the following are considered acceptable*

- *An average over all the valuation points falling within the two week period. (1 mark)*
- *An average from a valuation point at an equivalent time in each of the two weeks concerned. (1 mark)*
- *An average from the values on the last business day of month one and month two. (1 mark)*
- *Another specifically agreed valuation method. (1 mark)*

*HMRC requires AFMs to inform it of the approach chosen and for it to remain consistent. If an AFM needs to change the way in which the valuation is done the reason must be given on the first return following the change. (1 mark)*

- 12 Prepare a guidance note for the Board of ABC Fund Management Ltd on how it must deal with the topic of risk in the prospectus for its Global Fund. Your note should include a list of the risks and a brief explanation. (10 marks)

- *A brief assessment of the scheme's risk profile by investment compartment or sub-fund to present a clear picture of the risk profile of the scheme plus a statement that details of all the risks actually mentioned in the simplified prospectus may be found in the full prospectus. (1 mark)*
- *Including all of the following:*
  - *a statement to the effect that the value of investments may fall as well as rise and that investors may get back less than they put in. (1 mark)*
  - *a description in words of any risk investors have to face in relation to their investment, but only where such risk is relevant and material, based on risk impact and probability. (1 Mark)*

*Examples of Specific risks to be described are:*

- *The description should include a brief and understandable explanation of any specific risk arising from particular investment policies or strategies or associated with specific markets or assets relevant to the scheme. (1 mark)*
- *Including all of the following:*
  - *the entire market of an asset class will decline thus affecting the prices and values of the assets (market risk). (1 mark)*
  - *an issuer or a counterparty will default (credit risk). (1 mark)*
  - *a position cannot be liquidated in a timely manner at a reasonable price (liquidity risk). (1 mark)*

- *the investment's value will be affected by changes in exchange rates (exchange or currency risk). (1 mark)*

*The description should also mention, where relevant and material, the following horizontal risk factors that may affect the product:*

- *a performance risk, including the variability of risk levels depending on individual fund selections, and the existence, absence of, or restrictions on any guarantees given by third parties. (1 mark)*
  - *risks to capital, including potential risk of erosion resulting from withdrawals/cancellations of units and distributions in excess of investment returns. (1 mark)*
  - *exposure to the performance of the provider/third party guarantor, where investment in the product involves direct investment in the provider, rather than assets held by the provider. (1 mark)*
  - *lack of certainty that environmental factors, such as a tax regime, inflation will persist. (1 mark)*
- *The relevant risks should be shown in a priority based on scale and of materiality. (1 mark)*

13 a) Explain the role of the Financial Reporting Council in the UK. (5 marks)

- *The Financial Reporting Council (FRC) is the UK's independent regulator for corporate reporting and governance with the aim of promoting confidence, (1 mark)*
- *the FRC's five objectives are to promote:, max 2 marks)*
- *high quality corporate reporting and auditing*
- *high standards of corporate governance demonstrated by integrity, competence and transparency of the accountancy profession*
- *effectiveness as a unified independent regulator*
- *The functions exercised in pursuit of the five objectives can be summarised as follows: (max 2 marks)*
- *setting, monitoring and enforcing accounting and auditing standards as it has statutory oversight and regulation of auditors*
- *operating an independent investigation and discipline scheme for public interest cases*
- *overseeing the regulatory activities of the professional accountancy bodies to promote high standards of corporate governance*
- *The FRC believes that there are strong connections between the issues of corporate reporting, auditing, corporate governance and the professionalism of accountants. (1 mark)*

b) Name the FIVE bodies which fall under the FRC's control and explain the purpose of any TWO of them. (5 marks)

- *The **Accounting Standards Board, the ASB**, makes, amends and withdraws accounting standards. There is an increasingly important international dimension to this with the move towards the introduction of International Financial Reporting Standards in 2005. It is assisted by its six committees-the Urgent Issues Task Force, the Financial Sector and Other Special Industries Committee (which advises ASB on the suitability and compliance with ASB principles of industry SORPs), the Public Sector and Not-for-profit Committee, the Committee on Accounting for Smaller Entities, the Advisory committee on the OFR and the Advisory Panel on Life Assurance*
- *The **Auditing Practices Board, the APB**, plays a key part in the development of auditing and assurance services standards and their effective application. Its responsibilities have also been extended to the development of ethical standards relating to the independence, objectivity and integrity of auditors. It has recently published a consultation document on this subject. As in the case of the ASB, there is a strong growing international dimension to this work.*
- *The new **Professional Oversight Board For Accountancy, the POBA**, has three main roles. First the Government plans to bring forward legislation to delegate to it the statutory functions the Secretary of State for Trade and Industry currently exercises in relation to audit by authorising the professional accountancy bodies to act as supervisory bodies and to offer a recognised professional qualification. Secondly it will establish and oversee an independent Audit Inspection Unit to monitor the audit of major listed companies and other public interest entities. Thirdly, it will oversee the regulatory activities of the individual professional accountancy bodies, including education and training, standards, professional conduct and discipline.*
- *The **Financial Reporting Review Panel, the FRRP**, enquires into apparent departures from the accounting requirements of the Companies Act 1985 in the annual accounts of large companies and where necessary seeks remedial action, being empowered to apply to the court for that purpose.*
- *The **Accountancy Investigation and Discipline Board, the AIDB**, will be an effective and transparent investigation and disciplinary scheme to handle public interest cases an important part of the new arrangements..*

**Continued overleaf**

**Answer ONE question in this section**

14 A recently appointed trustee of SPQR Pension fund (which uses a broad range of assets to achieve its investment strategy), has questioned the term *benchmarking*.

a) Define the term *benchmarking*. (2 marks)

- A benchmark is a reference or standard level of performance that can be cited in an expression of return objectives set for the in-house or externally-appointed portfolio manager, or used as a comparator for a fund's actual return. (1 mark)

*The use of benchmarks takes us into the area of relative performance measurement and which benchmark is used is a matter for the parties to agree but it should be both relevant and realistic in the context of the fund's investment objectives and policies. (1 mark)*

b) Identify the common types of benchmarks. (4 marks)

- Common benchmarks are one or other of:
  - a relevant equity, bond or other market index (1 mark)
  - like funds, also known as peer group or universe comparison (1 mark)
  - a custom benchmark, which may be a composite index or a portfolio (1 mark)

*Indices measure changes over time and financial indices provide an indication of the general direction of a market and a measure of the movement in that direction. (1 mark)*

c) Explain the principal considerations when choosing a benchmark. (15 marks)

*It is therefore thoroughly reasonable to invite a fund manager to accept that meeting or beating the performance of a relevant index is an appropriate standard of performance (1 mark). Need to consider the following factors:*

- Which index/period and what tolerance? (1 Mark)

*To meet the relevance test, the index constituents should include or comprise securities that the fund manager may select for investment. (1 mark)*

*It would be relevant to choose the FT-SE 100 index as a benchmark for a UK Blue Chip fund for instance but not for a Global Growth or Bond fund, for which one of the Morgan Stanley Capital Indices (MSCI) is likely to be more relevant. (1 mark)*

*Similarly, if the fund invests across a range of asset classes, such as a balanced or mixed fund, then the FT-SE 100 alone is not valid as a sole benchmark because it measures equity performance only. (1 mark)*

*In such cases a composite index combining given weightings of (say) the FT-SE 100 for the fund's UK equity component and the Merrill Lynch Bond Index for its US fixed income securities, and so on, would be appropriate. (1 mark)*

*Additional factors to consider when choosing a benchmark:*

*Another consideration is if the fund has a themed investment objective, such as investing only in companies judged to be 'ethical' or 'socially responsible'. (1 mark) Although there has been significant development by data providers, including FT-SE, of special indices, it is quite likely that such an objective requires construction of a composite index or a custom portfolio as the benchmark. (1 mark)*

*Although the purpose of using an index as a benchmark is as a target or a comparator, its existence may well influence the stock selection and weightings policy adopted by a manager who is more concerned to meet rather than beat his benchmark. (1 mark)*

*For instance, a fund manager given a return objective of exceeding the FT-SE 100 by 1% per annum is likely to construct the fund's portfolio with core holdings in the main constituents of the index and at much the same weight. (1 mark) This can cause a portfolio to be unduly exposed to just a few sectors - the FT-SE 100 currently is skewed towards oils and financials. (1 mark)*

*Whether "per annum" in the above example is fair or realistic to use with a benchmark index is again a matter for negotiation. (1 mark) Factors to be considered will be:*

*a.) the size of the fund (1 mark) – initially it may not be large enough to achieve a sensible spread or weighting in index stocks and over time it may grow to be too large for it to invest the desired weight in certain companies; (1 mark)*

*b.) the maturity of the market (1 mark) – it may be a growing market with regular new listings or a contracting market due to mergers and takeovers*

*c) the liquidity of stocks – the availability of shares (1 mark)*

d) Explain the methods of evaluating the performance of a fund (9 marks)

- *Evaluating Performance:*

*These factors may well persuade the parties to settle on an expression of objectives as being “to equal the performance of the XYZ index in each of the first two years and to exceed it by x% in each of the following two years and by y% thereafter”. (1 mark)*

*A further extension of the expression would be to include the SD of the expected return, either absolute or relative to the index SD, thereby setting a range within which the fund can perform. (1 mark)*

*Peer group or universe comparison has already been discussed when considering performance evaluation by investors. However, when evaluating the portfolio manager’s relative performance, it is more appropriate to use bid-to-bid or mid-to-mid prices to value the underlying assets, rather than the offer-to-bid basis. (1 mark)*

*This is because the manager has little influence over market dealing spreads and so it is a fairer and more accurate reflection of management skills to value the portfolio on a consistent pricing basis. (1 mark)*

*A final general comparison is to benchmark the fund against the performance of a risk-free asset, such as a Government bond and to calculate:*

- (a) *market risk premium (MRP) ie the extra performance to be achieved by investing in the chosen market - the movement in the market index less the risk-free return; (1 mark)*
- (b) *portfolio risk premium (PRP)) ie the extra performance achieved by the fund over and above the risk-free return. (1 mark)*

*If the market index is chosen as the fund’s benchmark, then PRP becomes known as the fund’s ‘alpha’ ( $\alpha$ ), (1 mark) which is more broadly defined as the extent to which a fund outperforms its benchmark portfolio. (1 mark)*

*Sometimes this measure is known as Jensen’s alpha, after the mathematician who developed it by extending the application of CAPM. (1 mark)*

15 a) Describe FIVE of the parties of who can and cannot be registered on the register of unit trusts. (5 marks)

1 *The registration of units is limited to legally recognised persons, including individuals and corporate bodies. Examples are John Robert Smith, John Smith Limited and John Smith Plc. (1 mark)*

2 *There are some unusual corporate bodies which are also acceptable, such as NHS Trusts which, despite the name, are in fact corporate bodies normally incorporated by a specific Act of Parliament and certain government bodies such as The Public Trustee and The Treasury Solicitor who both generally execute documents under Seal. (1 mark)*

3 *Partnerships, unincorporated bodies such as clubs and official capacities such as “The Trustees of .....*” or “*The Treasurer and Secretary of .....*” would all normally not be accepted for registration. (1 mark)

4 *Limited partnerships (i.e. those registered with the Register of Companies) are acceptable. (1 mark)*

5 *The register, however, does not necessarily reflect all entitlement to units/shares as those held for the manager or for anyone holding bearer certificates may not be recorded (1 mark)*

6 *No notice of any trust (express, implied or constructive) is binding on the AFM and trustee and, although such notice may be entered on unit trust registers, such practice is prohibited in the case of a company or OEIC register and most unit trust registrars adopt the same approach. (1 mark)*

7 *The registrar is unable to act on documents such as Deeds of Appointment where the holders may be trustees of a private trust and the trustees are changing. (1 mark)*

b) Outline what scenarios give rise to a transfer of ownership of units/shares by *Operation of Law* and explain the process required to complete the transfer. (6 marks)

1 *In the case of a joint holding of units/shares, on the death of one of the holders the surviving holder(s) are recognised as having title to the units/shares. The registrar needs to see a death certificate together with unit/share certificates (if in issue). The death is then registered and the certificates enfaced or new certificates in the survivors’ names issued. (1 mark)*

2 *If either a sole holder or the last surviving holder dies, authority to deal with the holding rests with the executors or administrators of the deceased holder. The registrar must see the Grant of Probate or Letters of Administration in such cases to establish title. (1 mark) The executors or administrators can complete a simple Letter of Request form to have the holding placed in their names as unit holders, without reference to the deceased. (1 mark)*

- 3 *Alternatively, they may transfer the units/shares to beneficiaries by means of the usual stock transfer form or, of course, sell the units/shares back to the AFM. (1 mark)*
- 4 *This type of transfer may also take place in the event of bankruptcy or, in the case of corporate holders, liquidation. The registrar needs to see satisfactory evidence of the appointment of the person claiming title to the units/shares, such as a receiver, before registering any transfer. (1 mark)*
- 5 *Until the units/shares have been transferred into the name(s) of the new holders(s) the legal representatives, such as executors, are not entitled to receive notices or attend or vote at any meeting of unit/shareholders. (1 mark)*
- c) Explain the process of settling CIS trades through CREST and refer to any benefits for AFMs. (7 marks)
1. *Process referred to as a residual settlement transaction. This provides secure delivery of physical stock and use of CREST's assured payment mechanism. (1 mark)*
2. *CREST settlement of CIS investments follows a different process to settlement of securities through CREST's central settlement system. (1 mark)*
3. *CIS investment deals are described within CREST as residual. With residual securities, the unit/share certificate and stock transfer form are passed from the seller to buyer (normally via their brokers) either inter-office or through the CREST Courier and Sorting Services (CCSS). (1 mark)*
4. *Residual settlement of CIS investment differs from residual settlement of corporate securities because in the normal course one of the parties to a residual CIS transaction will always be the AFM. (1 mark)*
5. *This means that settlement risk can be reduced, since the AFM can ensure that transfer of title is co-ordinated with payment. (1 mark)*  
*There are a number of benefits to be gained by CREST members and AFMs, which include:*
  - *the system complements the electronic trading system EMX introduced in 2000; thus the CIS industry is able to use infrastructure that is already proven and very firmly established; (1 mark)*
6. *CREST settlement ensures the secure and efficient delivery of stock and payment of cash, reducing the elements of settlement risk in existing procedures (i.e. it speeds up delivery of cleared funds for purchases and redemptions); (1mark)*
7. *Residual settlement is the first phase. Further developments would be required to enable the integration of AUTs and ACDs in CREST's central settlement system allowing the electronic registration of units/shares to take place and provide even greater efficiencies. (1 mark)*

- d) Identify the benefits of distributions paid via Bankers Automated Clearing Services (BACS) for both the holder and the registrar/CIS. (7 marks)

*For the holder:*

- *No risk of a warrant being delayed or lost in the post*
- *Income is credited as cleared money on the due date, i.e. there is no three-day cheque clearing delay*
- *There is no need to visit the bank or building society to pay in the warrant thus speeding up the re-investment timescale*
- *The tax voucher can still be sent direct by post to inform the unit/shareholder of the amount credited to the bank account*

*For the registrar/CIS:*

- *Paper handling is reduced*
- *Reconciliation problems are reduced*
- *Costs are reduced significantly*

- e) Explain how and why Authorised Persons, under the FSMA 2000 reconcile their CIS positions, and refer to actions undertaken by the Registrar of CISs. (5 marks)

1 *Those holders who are authorised persons under the FSMA 2000 (such as stockbrokers) may have to meet requirements under the regulation of their business to reconcile their holdings of CISs as shown in their records with those of the registrar. (1 mark)*

- *They are required to carry out such reconciliations monthly with their own record of dealing. (1 mark)*

2 *Such holders may reconcile their position using:  
The last statement or tax voucher issued to them by the registrar with records of contract notes issued subsequently (1 mark)*

3 *The FSA has confirmed that it is not necessary for registrars to issue monthly statements. In some cases however, if the authorised firm has difficulty in concluding the required reconciliation, the firm may need to request from the registrar a current statement of his account(s) as shown on the register. The registrar is required to supply to a holder or his authorised representative, at his request and free of charge, a copy in print of the entries on the register relating to that holder. (2 marks)*

**Answer ONE question in this section**

- 16 As a manager in the Unit Trust Valuation team, you have been asked to meet a recently recruited Marketing Manager who has limited knowledge of Fund Management. Your task is to give a brief overview of the various constituents of a fund valuation (omitting derivatives as this will be covered in depth at a later date) and highlight the components which you would look at first if the unit price has moved contrary to the fund's benchmark index. *(30 marks)*

*1 (1 mark each but must have some explanation of the point)*

- 1 Up to date list of stocks/shares held with Book Cost*
- 2 Relevant pricing basis*
- 3 Current prices of stocks/shares held*
- 4 Single or dual pricing*
- 5 Notional Broking Charges*
- 6 Outstanding Settlements*
- 7 Creations/Cancellations*
- 8 Cash*
- 9 Exchange Rates*
- 10 Dividend or interest income*
- 11 Interest on cash*
- 12 Initial Charge*
- 13 No of units in issue*
- 14 Chargeable Expenses (each can gain a mark if explained)*
  - a. Fees : AFM; Depositary; Safe custody; FSA; Auditor's; Registration, Possibly Interest Expenses ; Interest Distribution*
  - b. Non-chargeable Expenses*
  - c. Stockbrokers' fees; overdraft interest; foreign exchange*
  - d. Tax Income Tax; Withholding Tax; Stamp Duty; SDRT; VAT*

*2 1 mark for each if explanation given*

- 1 Prices of stocks/shares (movement from previous valuation)*
- 2 Trade(s) missed*
- 3 Corporate Action(s) missed*
- 4 Dividend Income/Interest not accrued*
- 5 Incorrect Cash Balance(s)*
- 6 Creations/Cancellations missed*
- 7 Incorrect No of units*
- 8 Incorrect Exchange Rates*
- 9 Pricing basis changed from previous valuation point*

*3 marks available for structure, logic and cohesion of the answer, awarded at the marker's discretion.*

- 17 The trustees of the XYZ fund, a UK OEIC, have identified that a number of minor errors and material breaches were made in pricing the fund recently. You have been asked to identify the possible consequences of both the minor errors and material breaches, and explain what action should be expected of the fund manager. (30 marks)

*NB If some of the general points appear in the other part of the question, then credit should be given e.g. Major answer 1 if given in Minor can still be given credit – but only once*

*Minor error:*

- 1 Many errors will be so minor as to not change the fourth significant figure. For instance, the single pricing example earlier in this chapter calculated a fund value of £8,512.50 (and a price of 85.13p per unit). If the cash at bank figure of £300 were incorrectly calculated, adding 50p to the figure, the total fund value would have been stated as £8,513.00, still resulting in a price of 85.13p per unit. (1 mark)*
- 2 For the purpose of regulatory compliance, where the fourth significant figure is not affected, no pricing error has occurred and no regulatory breach is recorded. (1 mark)*
- 3 Where the magnitude of the error is less than 0.5% the error is described as being below de minimis (the minimum level at which the AFM is required to recalculate all deals performed). (1 mark)*
- 4 However, the regulations grant some flexibility to the trustee/depositary to judge an event appropriately. If the trustee/depositary is satisfied that the incorrect pricing is of minimal significance, the valuation must still be corrected but reimbursement need not be made. (1 mark)*
- 5 Equally, where the trustee/depositary considers that an investor dealing when an error has occurred below de minimis but has suffered material loss, it can require the AFM to compensate the investor. (1 mark)*
- 6 This extends to either reimbursing or compensating any investor or former investor. (1 mark)*

*Material Breaches:*

- 1 An AFM has a professional duty to ensure that prices used to value the investments are correct. (1 mark)*
- 2 The AFM also has a duty, if incorrect pricing has taken place, to take action to rectify the valuation. (1 mark)*
- 3 Regulations require a price to be quoted to four significant figures. (1 mark)*
- 4 the important feature in assessing a pricing error is the percentage by which the calculated figure differs from the correct figure. (1 mark)*
- 5 However, suppose the fourth significant figure is changed and so the event is recorded as a pricing error. (1 mark)*

- 6 Any pricing errors exceeding the de minimis limit (ie, incorrect pricing of plus/minus 0.5% or more of the price of a unit/share) must be reported by the trustee/depositary in a quarterly return to the FSA. (1 mark)
- 7 Where the magnitude is greater than 0.5% the error is above de minimis and all deals executed with prices based on that valuation point must be recalculated. (1 mark)
- 8 and to the AFM reimbursing the scheme (or receiving compensation) for any benefit incorrectly gained. (1 mark)
- 9 All these steps are taken with the agreement of the trustee/depositary. (1 mark)
- 10 On discovery, incorrect prices (to the fourth significant figure) must be recorded by the AFM. (1 mark)
- 11 The errors should also be reported to the trustee/depositary. (1 mark)
- 12 Action should be taken to avoid repetition of the breach. (1 mark)
- 13 Correction is required even if the correct price would have been within the maximum and minimum prices permitted by the regulations.(1 mark)
- 14 It may not be practical or even legally permissible for the manager to seek compensation from the unit/shareholders if they have benefited from an incorrect price. (1 mark)
- 15 The manager needs to consider his legal position and commercial implications when deciding whether to seek compensation. (1 mark)

*1 mark for each of these being covered:*

<b>Compensation Decisions</b>	<b>more than 0.5%</b>
<i>Fund Gains (creation- too high or cancellation - too low)</i>	<i>Trustee to compensate AFM from fund</i>
<i>Fund Losses (creation - too low or cancellation - too high)</i>	<i>Trustee directs AFM to compensate fund</i>
<i>Incoming Unit Holder Loses (offer price - too high)</i>	<i>AFM to compensate incoming unit/shareholders</i>
<i>Outgoing Unit Holder Loses (bid price - too low)</i>	<i>AFM to compensate outgoing unit/shareholders</i>

*Consequences (1 mark each point)*

- Manager may have to pay compensation, as decided by the Trustee*
- Manager can seek compensation from unitholders (legally possible)*
- Loss of customers (especially if compensation claimed)*
- Loss of reputation*

**End of Paper**