CFA INSTITUTE | Centre for Financial Market Integrity

M. Hubert Reynier
Chairman, Standing Committee 5
International Organization of Securities Commissions
C/Oquendo 12
28006 Madrid
Spain

10th March 2009

Re: Standing Committee 5 Hearing 11th March 2009.

Dear Monsieur Reynier,

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") greatly appreciates the opportunity to contribute to the hearing of Standing Committee 5 on Investment Management. We deeply regret being unable to present our views in person at this meeting. However, we sincerely hope that the points set-out herein will be of value to the Committee's discussions on the three agenda items, namely: investment managers' due diligence; the regulatory issues raised by suspensions of fund redemptions; and the regulatory issues raised by money market funds.

The CFA Institute Centre promotes fair, open, and transparent global capital markets, and advocates for investors' protection. We are supportive of IOSCO's efforts in the area of Investment Management and accordingly attach great importance to the ongoing work of Standing Committee 5.

Our observations are as follows:

i.) Investment Managers' due diligence

Recent scandals have merely underlined the importance of a comprehensive and robust due diligence process for investors' protection. We are concerned that standards of due diligence vary significantly not only across the product spectrum but also across international jurisdictions. Our primary consideration is that the depth of the due diligence process should be commensurate with the level of regulatory standards—and the level of enforcement of those standards—in the location of the manager and of the fund itself. To safeguard investors, it should be incumbent upon the manager[1] to strengthen its due diligence process to a standard that is consistent with the highest common denominator of investor protection. This would mean that the overall level of comfort obtained from the combination of regulatory standards and the manager's due diligence process is balanced such that due diligence is strengthened where regulatory standards are lax. This would achieve a common overall level of investor protection irrespective of the regulatory jurisdiction.

[1] We determine the "manager" to be those persons charged with governance of the fund.

Charlottesville New York Hong Kong London
10th Floor, One Canada Square
Canary Wharf, London E14 5AB
United Kingdom
+44 (0)20 7531 0750 tel
+44 (0)20 7531 0767 fax
infoeu@cfainstitute.org
www.cfainstitute.org

Moreover, the depth of the due diligence process should also be commensurate with the level of complexity embedded in the investment policy of the fund. This would apply to both the strategy of the fund and the instruments held. An extension of our previous argument is that investments in structured finance products or complex derivatives—particularly in retail schemes—should necessitate a higher level of due diligence than for 'vanilla' instruments. In particular, prior to investment and on an ongoing basis, managers should ensure that a detailed examination of the structure and function of complex securities is conducted; how these securities are traded; their liquidity characteristics; and any other risks or vulnerabilities, including counterparty risk and statistical assumptions. To this end, it would be purposeful to establish regular communication channels with the risk management function (which should operate independently to safeguard the process).

Additionally, investment advisors[2] have a fiduciary responsibility for due diligence that should extend beyond the eligible investment universe. In our view, investment advisors also have a duty of care to ensure an adequate level of skill, experience and resources within the investment team, such that the investment strategy and objective can be executed without creating undue operational risk. In essence, the quality of human capital should feature more prominently in the due diligence process.

The risks inherent in the investment policy of the fund should also be clearly and prominently disclosed in an understandable manner in all relevant marketing materials. This would enable customers to conduct their own due diligence as to the suitability of the fund for their investment purposes. Moreover, the due diligence process should be made more transparent, so that all relevant parties (clients, regulatory authorities, etc) can assess the appropriateness of the procedures followed by the manager. Presently, there is too much emphasis on the end result with insufficient disclosure of how that result was achieved.

<u>ii.) The regulatory issues raised by suspensions of fund redemptions</u>

The ability of the manager to meet redemptions is a function of the liquidity risk profile of the fund. In particular, the manager should give due consideration to the liquidity of the fund's assets having regard to the frequency of unit/share dealing in the fund. This implies that where the fund is predominantly invested in relatively illiquid assets, the redemption frequency should be constrained, so that the periodicity of fund redemptions is broadly consistent with the time taken to liquidate investments. The alternative approach of holding a higher portion of the fund's assets in cash or drawing down on overdraft facilities is likely to be detrimental to investors as such practices would likely inhibit the manager from achieving the fund's stated objective.

Aside from constraining the redemption frequency for relatively illiquid funds, it may be appropriate for the manager to limit investors' redemption capability to a percentage of units held over a prescribed limited redemption procedure. We feel that such constraints better align the expectations of the investor and the manager with the investment policy of the fund. Crucially, however, any such constraints to customer dealing should be clearly disclosed up front in the prospectus.

[2] We determine the "investment advisor" to be those persons responsible for strategic asset allocation.

However, we recognise that in times of significant illiquidity, there are some circumstances when closing a fund is the only way to protect the interests of buyers, holders, and sellers simultaneously. Notwithstanding the considerable reputation, regulatory, and commercial issues involved in closing a fund to redemptions, managers may face genuine difficulties in treating all customers fairly when bid prices fade significantly from marks established in thin or inactive markets.

In these circumstances, it is inappropriate for the manager to charge fees on these (illiquid) assets. In effect, assets that cannot be sold by implication cannot be managed.

Furthermore, it would be in investors' best interests if the manager disclosed, where possible, the nature of any special arrangements with specific classes of investors and the conclusions drawn thereon regarding their potential impact on the Fund. Disclosure of conflicts of interests protects investors by providing them with the information they need to evaluate the objectivity of their manager's actions, and to make their own determination regarding the circumstances, motives, or possible bias of the manager's decisions.

<u>iii.) The regulatory issues raised by money market funds</u>

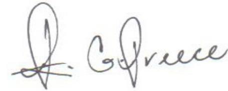
Our key concern is that investors need better disclosures to fully inform them of the risks inherent in money market funds and their equivalents. In short, the names common with these funds (such as "cash fund") may inadvertently give investors a false perception of the risks (or relative lack of risks) manifest in these funds.

It is often the case that money market funds invest in range of instruments of differing maturities and hence differing liquidity. For example, it is common for money market funds or cash funds to hold a variety of floating rate notes or other variable rate bills of relatively high credit quality in addition to cash deposits. Such floating rate investments often comprise a significant proportion of the fund's assets. Moreover, some money market funds may hold asset-backed paper with variable reset coupons. The principal concern from an investor protection standpoint is that the variable interest payments on these types of securities create a perceived safety of capital from market price risk, when their maturity profile (often greater than 15-20 years) is inconsistent with such perceived low risk. We believe that holding such assets is inconsistent with the term money market or cash fund.

It is essential that better disclosures are made of the types of instruments held in these funds, in addition to disclosures of the risks inherent in the investment policy (including credit and liquidity risk). Such disclosures should be made explicit in retail marketing materials, so that retail customers are fully aware that such funds do not merely hold cash.

Should you wish to obtain further elaboration on any of the points expressed herein, please do not hesitate to contact us.

Yours faithfully,



Charles Cronin, CFA
Head, CFA Institute Centre,
Europe, Middle East and Africa

+44 (0)20 7531 0762
charles.cronin@cfainstitute.org

Rhodri G. Preece, CFA
Policy Analyst, CFA Institute Centre,
Europe, Middle East and Africa

+44 (0)20 7531 0764
rhodri.preece@cfainstitute.org