INCORRECT PRICING OF AUTHORISED COLLECTIVE INVESTMENT SCHEMES – GUIDANCE NOTE ON CORRECTION AND COMPENSATION

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1. Introduction

1.1 This Guidance Note sets out standards of conduct for occasions when incorrect pricing of authorised collective investment schemes takes place and when the Commission considers compensation is required. The Commission would expect managers* and designated trustees/custodians (henceforth trustees) of authorised collective investment schemes to observe this guidance when complying with the Rules made under the Protection of Investors (Bailiwick of Guernsey) Law, 1987 as amended ("the Rules"). This Guidance Note describes the way in which the Commission will apply the Rules in practice when monitoring and enforcing compliance. It does not constitute legal advice by the Commission; interpretation of the Rules is ultimately a matter for the Courts.

1.2 The Commission's general intention is to require managers and trustees to exercise due diligence over pricing and for managers to compensate investors unless the error is of minimal significance. This Guidance Note gives a wide discretion to the trustees of authorised collective investment schemes to determine in any particular case whether or not compensation is required. The trustee has a fiduciary duty and must decide, in consultation with the manager, and in accordance with that duty, how any such discretion should be exercised in any particular case. This Guidance Note is designed to ensure consistency but is not intended to be exhaustive.

1.3 This Guidance Note introduces a reasonable de minimis figure but at the same time indicates to managers and trustees the **need for tight controls over pricing routines** to reduce the likelihood of incorrect pricing arising. It is intended to ensure that there is universally tight control over pricing throughout the industry to the benefit of investors generally whilst minimising the need for costly investigation into the consequences of very minor cases of incorrect pricing.

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* In this note manager means both designated and principal manager.

2. Guidance on Pricing Controls by Manager

The Commission expects that there is an appropriate demonstrable control environment in place if managers are to rely on the de minimis provisions.

If such controls are not in place, managers may not take advantage of the de minimis provisions.

This section sets out the minimum checks which the Commission expects managers to carry out.

2.1 Share prices and currency rates used should be up-to-date and from a reputable source. The reliability of the source of prices and rates should be kept under regular review and doubtful prices or rates questioned.

2.2 If a third party is used to carry out the pricing function the manager still remains responsible for correct pricing and should ensure that the third party acknowledges the manager's responsibilities in this respect.

2.3 Where the pricing function is delegated the manager must satisfy himself that the delegate's system is robust and will produce accurate results. The manager should review the outputs from the system at least annually and on any significant system change.

2.4 Unless the valuation and record keeping systems are integrated, the valuation output should be agreed with the manager's records of the fund at each valuation point. In addition, the manager's records, including debtors and creditors, should be agreed with the trustee's record of stocks and both capital and income cash at least monthly, with reconciling items followed up promptly and debtors reviewed for recoverability.

2.5 Systems should be in place whereby securities deals are formally confirmed as quickly as possible to the manager (or delegate). All deals to which the fund is committed must be included in the valuation. A cut-off procedure should be in place to guard against omissions or duplications.

2.6 Where prices are obtained otherwise than from the main pricing source (eg unquoted, suspended or illiquid stocks) the manager should maintain a record of the source and basis for the value placed on the stock. These should be frequently reviewed.

2.7 A system should be in place to ensure that investment and borrowing powers are not breached and that, if breaches occur, they are identified and rectified promptly.

2.8 A system should be in place to ensure that dividends are accounted for as soon as stocks are quoted ex-dividend unless (as with some stock) it is more prudent to account for them on receipt. Unless a longer interval is more appropriate for reasons of materiality, fixed interest dividends and interest should be accrued at each valuation point. Similar considerations apply to the expenses of the collective investment scheme.

2.9 The full tax position should be reviewed regularly, including any assumptions made about the recoverability of overseas taxes deducted at source and about applicable tax rates. Adjustments for substantive changes (e.g. to tax profile or likely tax charges) should be made when they occur.

2.10 In the case of dual-priced funds, a justification for the figures included for dealing expenses and commissions included in the price should be reviewed at least quarterly for each market. In addition adjustments should be made when substantive changes in a market's costs occur (eg changes in the rate of stamp duty).

2.11 Managers should fix a limit for certain key elements of a valuation such that any movement beyond that limit is investigated and the investigation and evidence of the outcome should be evidenced by the signature of a suitably senior member of staff. Such key elements include: share/unit price; stock prices; exchange rates; income accruals and expenses, and tax.

If a price has remained unchanged for a fixed period it should be investigated to ensure that movement in the price has not been overlooked.

2.12 Cash should be reconciled at the bank account regularly. Outstanding items should be followed up promptly and a full reconciliation sent to the trustee at least monthly.

2.13 Controls should be in place to ensure the correct number of shares/units in issue is recorded at each valuation point. This should be reconciled with the share/unitholder register at least monthly.

2.14 A copy of the valuation should be sent to the investment adviser/investment manager at least weekly or, in the case of funds which value at more than weekly intervals, on each occasion that a valuation is effected. He should check that the correct securities are recorded and advise the Manager immediately of any discrepancies.

3. Guidance on Pricing Checks by Trustee

3.1 The trustee has a duty to ensure that the manager's pricing operation is properly controlled. The following outlines the **minimum** checks which the Commission will expect the trustee to carry out to satisfy itself that the manager's pricing operation is adequately controlled so that the likelihood of incorrect prices will be minimised.

3.2 Primarily the trustee should carry out a thorough review of the manager's overall pricing system. The trustee should analyse the manager's controls to discover the extent to which they can be relied upon. These reviews should be carried out at the start of the trustee's appointment (the Commission would expect such reviews to be carried out no later than one month after the effective date of appointment) and on any major change to the manager's system(s). The manager's systems should be kept under frequent review (at least annually) to see that they are being adhered to. A check of the manager's whole valuation should be carried out at least every six months. Where problems have occurred, or systems are new, the trustee's level of checking should increase accordingly.

Where pricing is delegated the same principles apply.

4. Regulatory Position

A manager must be able to demonstrate that he has complied with the minimum control requirements set out in this Guidance Note. Evidence of persistent/repetitive incorrect pricing, or incorrect pricing consistently in the manager's favour, is likely to make this more difficult to demonstrate. Compensation may be required where the manager would otherwise derive material benefit from the use of incorrect prices.

A trustee must be able to demonstrate that he has properly reviewed – and kept under review – the manager's pricing systems and seen evidence of the manager's operation of his controls. The trustee should confirm to the manager in writing, at least annually, that the manager's pricing systems have been reviewed, and whether or not they meet the minimum standard.

5. Guidance on Incorrect Pricing

5.1 All instances of incorrect pricing amounting to 0.1% or more of the price of a share or a unit must be recorded, reported to the trustee and action taken to avoid repetition **as soon as they are discovered.** All instances of incorrect pricing amounting to 0.5% or more of the price of a share or unit must be reported by the trustee to the Commission. The appendix to this Guidance

Note sets out the relevant information that should be disclosed when making a report to the Commission._ The paragraphs below cover action to be taken as regards compensation for incorrect pricing.

5.2 *Prices found to be incorrect by less than 0.5%*

Provided that the manager can demonstrate compliance with the relevant provisions of 2.1 to 2.14 above, where a dealing, creation or cancellation price of any share/unit is found to be incorrect by less than 0.5% of the price of that unit/share, compensation to share/unitholders or to or from the fund will not normally be required, unless the trustee decides otherwise.

5.3 Prices found to be incorrect by 0.5% or more

5.3.1 Where the dealing price of any share/unit is found to be incorrect by 0.5% or more of the price of that unit, compensation to share/unitholders will be required unless, exceptionally, the trustee considers that compensation is inappropriate. If so, the trustee must report the matter to the Commission together with his recommendation and justification.

5.3.2 Where a creation or cancellation has taken place at a price which is incorrect by 0.5% or more of the price of a share/unit, the trustee will normally require the transaction to be corrected and money paid into or out of the collective investment scheme.

5.3.3 Where the factor leading to an incorrect price continues (or has continued) in existence over a period of time, compensation will normally be required only on days where the price is incorrect by 0.5% or more of the price of a share/unit.

5.3.4 Where there is more than one factor at any one time which causes an incorrect price to be calculated, compensation will normally be required whenever, and so long as, the **combined effect** on any one day is 0.5% or more of the price of a unit.

5.4 Generally

5.4.1 In all cases where compensation is otherwise required, amounts due to reimburse share/unitholders for individual sums under £10 (or currency equivalent at the rate taken at the valuation point) will not normally need to be paid, although managers are free to pay such smaller amounts, or to make such smaller amounts up to a higher figure (eg £10).

5.4.2 The chart below is intended to show each of the different circumstances where incorrect pricing can occur and the effect of this Guidance on each. The succeeding paragraphs set out the procedure in each circumstance. Notwithstanding the paragraphs below, the trustee may agree to a payment from the fund following an instance of incorrect pricing, if he deems it appropriate.

(N.B. the word "normally" used throughout this section denotes "unless the trustee directs otherwise").

COMPENSATION CHART

LOSES GAINS	COLLECTIVE INVESTMENT SCHEME	MANAGER	INCOMING SHARE/ UNITHOLDERS	OUTGOING SHARE/ UNITHOLDERS
COLLECTIVE INVESTMENT SCHEME		A		
MANAGER	B		D	F
INCOMING SHARE/UNIT HOLDERS		C		
OUTGOING SHARE/UNIT HOLDERS		E		

5.5 *Dealing between collective investment scheme and manager whether or not units/shares are issued or repurchased from share/unitholders*

A. Collective Investment Scheme gains vis-a-vis the manager.
(Creation at too high or cancellation at too low a price).

INCORRECT PRICE BY LESS THAN 0.5% - normally no action.

INCORRECT PRICE BY 0.5% OR MORE – trustee will normally compensate the manager from the collective investment scheme.

B. Collective Investment Scheme loses vis-a-vis the manager.
(Creation at too low or cancellation at too high a price).

INCORRECT PRICE BY LESS THAN 0.5% - normally no action.

INCORRECT PRICE BY 0.5% OR MORE – trustee will normally direct the manager to compensate the collective investment scheme.

5.6 *Dealing between share/unitholders and the manager whether or not shares/unit are created or cancelled*

C. Incoming share/unitholders gain vis-a-vis the manager.
(New share/unitholders buy shares/units at too low a price).

INCORRECT PRICE BY LESS THAN 0.5% - no action.

INCORRECT PRICE BY 0.5% OR MORE – see paragraph 5.7.

D. Incoming share/unitholders lose vis-a-vis the manager.
(New share/unitholders buy shares/units at too high a price).

INCORRECT PRICE BY LESS THAN 0.5% - normally no action.

INCORRECT PRICE BY 0.5% OR MORE – the manager will normally compensate incoming share/unitholders.

E. Outgoing share/unitholders gain vis-a-vis the manager.
(Outgoing share/unitholders sell at too high a price).

INCORRECT PRICE BY LESS THAN 0.5% - no action.

INCORRECT PRICE BY 0.5% OR MORE – see paragraph 5.7.

F. Outgoing share/unitholders lose vis-à-vis the manager.
(Outgoing share/unitholders sell at too low a price).

INCORRECT PRICE BY LESS THAN 0.5% - normally no action.

INCORRECT PRICE BY 0.5% OR MORE – the manager will normally compensate outgoing share/unitholders.

5.7 Shareholders/Unitholders who gain vis-a-vis the manager

It may not be practical or even, in some cases, legally permissible for the manager to seek to recover money from share/unitholders where they have benefitted from an incorrect price. In such cases the manager will usually wish to consider his legal position, as well as the commercial implications, in deciding whether to seek to make such recovery.

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<u>Appendix</u>

Relevant information that should be disclosed by the Trustee when making a report to the Commission in connection with an incorrect pricing.

1. The name of the authorised collective investment scheme and, if applicable, the name of the class of the scheme affected by the incorrect pricing.

2. The date(s) the incorrect pricing occurred (it may extend over several valuation days/points).

3. The date the incorrect pricing was detected and by whom (for example, the Designated Manager, the Designated Trustee or another party).

4. The date the incorrect pricing was corrected.

5. The cause of the incorrect pricing (detailed information to be provided, rather than a brief comment such as "human error").

6. The extent of the incorrect pricing, expressed as a percentage of the net asset value of the scheme/class (as appropriate) on each valuation day affected.

7. Whether the scheme was over or undervalued as a result of the incorrect pricing.

8. The number of subscribing investors and redeeming investors that were affected by the incorrect pricing.

9. The number of investors that were compensated (if any) and the value of such compensation.

10. Details as to how the scheme was compensated (if at all) and the value of such compensation.

11. Details of any other compensation paid (for example, to the Fund Manager/Investment Adviser for loss of income).

12. The detailed action that has been taken by the Designated Manager and Designated Trustee to prevent recurrence.

13. An explanation relating to any delay in the notification of the incorrect pricing by the Designated Manager to the Designated Trustee or by the Designated Trustee to the Commission.

14. The Designated Trustee’s conclusions in respect of the incorrect pricing, including an indication as to whether additional checking is required (refer to section 3.2 of the Guidance Note).