

**Background Information - Late Trading and Market Timing**  
**The Investment Funds Institute of Canada**  
**December 11, 2003**

**Overview of IFIC's Commitment to Investor Trust:**

Millions of Canadians have achieved their financial goals through mutual funds in Canada and everyone should continue to be confident in the integrity and benefits of our industry. The Canadian Mutual Fund Industry recognizes that investor trust is a key prerequisite to the success of the mutual fund product. The member companies of IFIC have pioneered codes of conduct that lead the world and we are committed to maintaining the trust of every investor. Measures to ensure this commitment are under constant review for improvement. As a consequence, our members have consistently supported The Investment Funds Institute of Canada ("IFIC") in its efforts to ensure that investors' interests remain foremost in the minds of industry participants. IFIC's members are proud of the ongoing regulatory leadership IFIC has shown in the Canadian market and as a standard-setter globally. IFIC's committees and Board of Directors have given vital guidance to the CSA and compliance leadership to IFIC members.

For example, the industry worked tirelessly through IFIC before and after the release of the comprehensive report on mutual funds done for the Ontario Securities Commission ("OSC") in 1995. Our Committees and individual members assisted the OSC and the OSC-sponsored Investment Funds Steering Group in assessing and dealing with the issues that ultimately lead to the creation (again by IFIC, working with the Investment Dealers Association of Canada ("IDA")) of the Mutual Fund Dealers Association of Canada ("MFDA") as a self-regulatory organization for non-IDA distributors in 1997. On the way, IFIC, on its own, provided the industry leadership needed to develop comprehensive rules on sales practices (since adopted by the securities regulators as National Instrument 81-105), mandatory requirements for the reporting and supervision of personal trading by fund managers and authoritative guidance on a host of other regulatory issues.

In 2003, IFIC continues to work closely with the OSC and other CSA participants to develop and implement a comprehensive corporate governance regime for mutual funds, maintaining its reputation for proactive guidance to the industry on issues vital to the maintenance of investor confidence.

**International Leadership:**

On the global scene, IFIC's standards are among the most extensive and precise of any mutual fund trade association in the world. IFIC continually is asked by other countries for guidance on its standards (*e.g.* recently U.K., U.S.A., China, South Africa and Brazil). As a membership organization, Canada's IFIC is a world leader in the precision of its codes of conduct, industry 'best practices' and statistical reporting.

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Past examples of these standards, which may be unique for fund associations worldwide for their extent and precision, include (in addition to the work on sales practices and personal trading already discussed): guidelines for error correction; a Code of Practice for distributors outlining responsibilities to investors; best practices for processing transactions where clients choose to exercise rights of withdrawal and rescission; and, of direct relevance to dealing with abusive market timing, guidelines for the “fair valuing” of portfolio securities, which will be discussed in greater detail.

These codes, guidelines and checklists give not only administrative guidance but ethical and compliance guidance. The industry is proud of these initiatives and continues daily to amend, clarify and add to them through IFIC and IFIC’s work with CSA members.

IFIC’s members have encouraged IFIC to work with regulators to insure that smart regulation is in place that is not duplicative or overly paternalistic. The industry, through IFIC, has always pushed for a well-regulated mutual fund industry. This has been part of the secret why the mutual fund product has bred, over the past 10 years, a new investor class of over \$420 billion, (equivalent almost to 40% of the retirement savings of Canadians).

The evidence shows that, to date, our work has been largely successful. The OSC and other Provincial securities regulators conducted an enhanced investigation of trading activities in the Canadian mutual fund industry about a year ago (in connection with the RT Capital high-closing issues). We are advised that this investigation did not uncover abusive trading activity.

### **United States Issues:**

Let’s look now at some of the issues that appear to have arisen in the U.S.A. There are two principal sets of issues – issues around the processing of trades in mutual fund securities after the 4:00 p.m. close or “late trading”, and issues around the short-term trading of certain mutual fund securities or “market timing.” We note that the OSC has also announced (on November 6, 2003) that it has forwarded a survey to Canada’s Fund Managers asking for information about these two issues. We welcome the OSC questionnaire and will cooperate in any way we can to strengthen confidence in the mutual fund industry of Canada. We have publicly supported this survey, as we do any regulatory initiative that helps our members and the regulators better define compliance responsibilities.

### **Late Trading:**

U.S. regulators have alleged that a number of U.S. mutual fund managers accepted trades from distributors after fund pricing had occurred and “backward priced” those trades - processing them at that day’s price (which, arguably, could have been disclosed to the

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individuals/institutions placing the late orders) instead of at the price determined at close of business on the following day.

The OSC survey reflects these concerns by defining late trading as occurring when purchase or redemption orders are received by a fund after the close of business on a given day, but are processed at that day's price rather than the next day's price.

Canadian and U.S. funds are required by securities laws (NI 81-102, s. 9.3, in Canada) to engage in "forward pricing". This means that orders received during a given business day are filled at the next price determined *after* they are received. Most Canadian funds price daily, at close of business. Accordingly, funds will set deadlines (usually 4:00p.m. Eastern Standard Time) for receipt of orders prior to the time of pricing. Acceptable orders properly received prior to the deadline on Tuesday, for example will be filled at the price determined at the close of business on Tuesday. Orders received after the deadline on Tuesday, will be filled at the price determined at close of business on Wednesday.

Subsection 9.1(5) of NI 81-102 requires that a purchase order be received by an "order receipt office of the mutual fund" before it can be deemed "received" and processed by the fund company. This is different from current U.S. regulation which permits an order to be deemed "received" by the fund company when it is placed with the dealer or broker.

Industry practice in Canada, therefore, is that orders are time-stamped when actually received by the fund company or, in the case of nearly 50% (by dollar value) of industry order flow, FundSERV Inc., the independent, industry-owned order-flow conduit. FundSERV procedures require that orders be time-stamped and processed when they are actually received.

Another key procedural difference in the U.S. fund industry is the prevalence of the "omnibus account." An omnibus account format involves the daily batching of client purchase/redemption orders for a particular fund received by a dealer and the forwarding of such orders to the fund company on an aggregate basis. The batching process may be done by the dealer, but is often outsourced to third-party service providers. As U.S. law allows orders to be deemed to be received by the fund company when they are received by the dealer, and as the batching process takes time and can only be completed after the day's orders are received by the dealer, it is not unusual for the fund company to actually receive the batched orders relating to a particular day's trading, after that day's price has been established. Omnibus accounts are not widely used in Canada and, in any event, are subject to the legal requirement that trades be received by the fund manager prior to the valuation time.

**ICI Response:**

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The U.S. mutual fund industry, through its trade association the Investment Company Institute (“ICI”) has called for an SEC rule that will require all mutual fund transactions to be received by the fund itself by 4:00 p.m.

**Canadian Response:**

Canadian law already requires orders to be in the hands of the fund manager to be deemed “received.” Combined with the forward pricing rule discussed above, these rules constitute a clear prohibition on late trading activity.

Canadian Fund Managers are well aware of their compliance responsibilities as well as the fiduciary duty they owe to their fund investors under Canadian securities laws.

In addition, there are significant structural differences that distinguish the Canadian mutual fund industry from its U.S. counterpart. In our case, the majority of mutual fund transactions are processed through Canadian chartered banks or the industry-owned utility FundSERV Inc.

Each of the banks, Investors Group and FundSERV Inc. have strict time-stamping protocols in place that effectively eliminate the possibility of late closing. This is fundamentally different from U.S. practice where time-stamping with respect to the majority of trades is handled at the individual distribution firm level. On a combined basis, Investors Group, Canada's six large banks and FundSERV account for in excess of 90% of all mutual fund trades in Canada in any given month.

**Market Timing:**

“Market timing” refers to a range of (usually short term) trading strategies undertaken by investors hoping to take advantage of anticipated market changes. At present, there are no specific prohibitions against market timing by investors, and no specific legal provisions requiring fund managers or other potential victims to take steps to prevent market timers from attempting to “time the market” through trades in mutual fund securities.

A Canadian fund manager is, however, required to “exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of [its] mutual fund(s)”, and in so doing, is required to “exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.” (OSA subs. 116(1)). This statutory fiduciary obligation does not form part of current U.S. securities laws.

The recent OSC survey of Canadian mutual fund managers seeks information about short term trading by fund investors intended to take advantage of pricing discrepancies between the fund price and the anticipated value of certain securities held in the fund's

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portfolio. These discrepancies in value arise when the values ascribed to one or more portfolio securities become “stale” as a result of intervening events that occur or become known after the security has been valued for fund pricing purposes. The OSC notes that “international funds are most vulnerable to this type of trading abuse as traders can exploit differences between time zones.” A typical case would be one in which an announcement occurring after the close of a foreign market causes a particular security listed on that market to open at a higher price the following day. A Canadian fund which included that security in its portfolio, priced at its last available market price, could be effectively undervalued. An astute market timer, aware of the announcement, would buy into the Canadian fund, then sell out as soon as the price of the Canadian fund was adjusted to correspond to the updated price of the foreign security. The market timer would not, however, know the exact number of the securities in the fund at a particular time or the effect of overnight currency fluctuations. This makes market timing and inherently risky investment strategy - even in the hands of professionals.

U.S. Securities regulators have alleged that certain U.S. fund managers have permitted or facilitated short term trading intended to take advantage of these pricing discrepancies. This is seen as contrary to the interests of long-term investors in the mutual fund as these transactions may generate transaction costs, which are borne by the remaining fund investors, and strip out gains which rightfully belong to all investors.

### **Measures to Deal with Short Term Trading:**

Investors may engage in short-term trading for a variety of reasons in addition to market timing strategies. Short term trading may occur in response to sudden financial needs on the part of the investor, or for a variety of financial planning reasons.

There are a variety of responsive techniques that can be utilized by fund managers to prevent or neutralize short term trading. These include Fair Valuing, imposition of short term trading fees; monitoring of trading patterns; and the declining or delay of orders, including switches, from identified “problem” sources. Each of these is discussed below:

#### A) Fair Valuing:

Fair valuing is the adjustment of portfolio security values, in appropriate circumstances, to reflect changes that would otherwise result in “stale” prices. IFIC has produced extensive Fair Valuing Guidelines (copies are available from the IFIC website) these guidelines include the following techniques:

- Valuation committees to review pricing and valuation;
- Establishment of enhanced resources dedicated to valuation of illiquid securities or others that are difficult to value;

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- Use of multiple pricing service providers and review of pricing service provider methodologies;
- Establishment of procedures to identify day-to-day price changes in individual securities over a threshold amount;
- Formal controls on to price overrides, such as documentation and supervisory approval and timely, independent review of all overrides;
- Ongoing monitoring of "stale priced" securities (i.e., those securities that have not changed in value over a specified period of time); and
- Review of "fair valued" securities sales proceeds against carrying value(s) prior to the sale.

B) Imposition of short-term trading fees:

Mandatory discretionary fees payable to the fund on redemption proceeds where securities are sold within a specified time period following purchase. Such fees reduce returns payable to short-term traders and compensate long-term fund holders for costs associated with short-term trading;

C) Monitoring of trades:

Monitoring of traders to determine patterns of trading and any abusive or disruptive practices.

D) Rejection of purchase orders, including switches:

From clients identified as exhibiting patterns of short-term or excessive trading.

E) Delaying of Switches:

Establishing the right to delay switches so as to offset the possibility of unusual returns from short term trading.

### **ICI Response:**

The ICI has called for the SEC to mandate a 2% redemption fee on any sale of long-term mutual fund shares within 5 days of their purchase. This fee will be paid to the fund so as to benefit long-term shareholders.

The ICI has also called for "steps" to make it clear that short-term trading in fund shares by fund personnel is not just "abhorrent but illegal."

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**Canadian Response:**

Canadian Fund Managers are well aware of the fiduciary duty they owe to their fund investors under Canadian securities laws.

Canadian fund managers have been aware of market timing and the harm it can wreak on long-term investors for some time. Firms that have identified suspicious short-term trading activity have already moved to implement discretionary short-term trading fees, like those advocated for by the ICI, which serve to protect longer-term investors and make market-timing activities financially unattractive. It should be noted that short-term trading fees are not always appropriate or necessary in every circumstance, and some flexibility should be preserved if possible. It should also be noted that many Canadian funds rely on U.S. or U.S.-listed securities, or ADRs for foreign investment, thereby eliminating trading time zone differences.

**IFIC Response:**

Two years ago, IFIC and its members developed comprehensive guidelines regarding the correct “fair valuing” of portfolio securities. These guidelines have been widely adopted. Canadian Fund Managers are well aware of the fiduciary duty they owe to their fund investors under Canadian securities laws. Fair valuing reduces or eliminates the pricing discrepancies that are exploited by market timers.

OSC staff and IFIC members are working together to alert the industry and develop best practices to assist in the detection and elimination of destructive market timing activity in the context of the Canadian mutual fund industry.