ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 58

Unit pricing: Guide to good practice

December 2004

ASIC
Australian Securities & Investments Commission

APRA

Unit pricing
Guide to good practice

Joint ASIC and APRA consultation paper

December 2004

Your views are sought – good practice guidance for unit pricing

This paper sets out views formed by APRA and ASIC on good practice in unit pricing, and seeks public comment on these proposals.

When the final guidance is issued in 2005, ASIC and APRA will expect increased understanding of good practice in unit pricing to be demonstrated at all levels of regulated organisations, and will also expect increased commitment to the implementation of effective unit pricing practice.

Background to Consultation Paper

Both APRA and ASIC, who have regulatory jurisdiction for aspects of the practice of life companies, superannuation providers and fund managers, have noted concerns about unit pricing practice in these entities in recent years.

This consultation paper includes proposals for guidance developed during the joint unit pricing review. This review has been undertaken by ASIC and APRA in the period from July to December 2004.

APRA and ASIC are working to develop a joint regulatory approach to assist industry participants understand and comply with their obligations in a consistent manner.

Methodology of the joint review

The joint review has built on the prior work of ASIC and APRA. During the review the regulators used their powers to release information to each other. Information was shared regarding more than 40 entities in which unit pricing issues have been addressed in the last four years. As well, the regulators visited product issuers and service providers, and consulted with industry bodies to obtain current views on unit pricing and outsourcing practice.

A survey ("the unit pricing survey") provided further detail about aspects of unit pricing, outsourcing and tax practice. The survey was sent to 95 entities. The response rate overall was 85% – replies were received from 29 fund managers (93%), 16 life companies (100%) and 36 superannuation funds (80%).

The survey process and the development of this proposed guidance have been subject to independent review by an external consultant.

The regulators would like to acknowledge the contribution of industry participants and industry bodies to date in the development of this consultation paper and the proposed guidance.

Good practice guidance

ASIC and APRA have not formed a view that there is only one preferred way to calculate unit prices. While a range of practice has been observed, this consultation paper indicates various practices that have the characteristics of good practice.

The matters raised in this guide have come to the attention of APRA and ASIC as important unit pricing issues. The proposed guidance does not limit the range of issues you need to consider in managing unit pricing.

Proposed status of final guidance

This paper is a consultation paper. This is not the final guidance.

When the guidance is finalised, after taking account of the views of industry participants and industry bodies, ASIC and APRA expect that your practices will measure up with that guidance. There may be unusual circumstances in which they will not, but then APRA and ASIC expect you will have a reasonable and documented basis for adopting another practice.

Review of unit pricing systems will continue to be an ongoing focus of regulatory surveillance.

Structure of this consultation paper

For a range of management, technical and consumer issues the paper:

- describes relevant aspects of each issue
- describes areas for particular attention, where you need to be on the alert. Based on what we have seen, these are common problems.
- outlines proposed guidance for good practice
- seeks your comments on this proposed guidance.

Consultation process

We invite you to comment on the proposals and on the questions we have included.

Please provide additional information (qualitative or quantitative) to support your comments and illustrate the issues or arguments you raise.

Submissions are due by **Friday, 18 February 2005** and should be sent to both:

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Introduction

Key findings of joint review into unit pricing

1. Unit prices may be calculated under intense pressure

Unit prices are often calculated in a high-speed, high-pressure environment. A manager of retail financial asset funds may calculate and publish many hundreds of unit prices every business day.

The range of unitised products available in the market is numerous and diverse. Even a single provider may administer many different unitised products offering a variety of investment choices. Many of these products and investment choices may no longer be actively marketed to new investors, and yet they still have to be administered. Certain investment choices may involve investment in other funds, either within the same provider or elsewhere, which are themselves also unitised.

All of this complexity adds to the pressure on achieving accurate unit pricing.

The same pressure may not be present for other entities, for example with wholesale funds or superannuation schemes, where there are fewer products or where pricing is less frequent.

Proposed guidance: Whatever the circumstances, product providers should implement reliable systems, procedures, controls and business continuity plans.

2. Unit pricing errors tend to be systemic

Errors in unit pricing systems may be undetected for long periods. There have been cases where preventable small errors in the calculation of fees, tax or transaction costs have accumulated over several years, ultimately affecting many thousands of unit holders.

Proposed guidance: Product providers should check data and valuation methodologies before data is used in unit pricing calculations. Product providers should obtain independent review of calculation methodologies. Product providers should manage old information technology systems effectively and ensure viable interfaces between old and new systems.

3. Effective risk management processes are essential

The less complex the systems and the more effective the checking and reconciliation procedures, the more likely it is that errors will be avoided, or quickly identified.

Proposed guidance: Effective risk management should ensure unit pricing systems and procedures are well designed and well understood, and should involve periodic independent reviews of those systems and procedures.

End-to-end process maps are a tool to assist risk management, and may be particularly useful if developed by the unit pricing team.

Attention to risk management is particularly important during times of change.

4. Unit pricing practice needs to be consistent with statements in related documents

Some errors have arisen, not because a unit pricing calculation method has been intrinsically faulty, but because the calculation method has not matched statements by the product provider about that method. Errors have arisen, for example, regarding asset valuation and transaction cost methodologies and regarding fee and tax treatments.

Proposed guidance: Product providers must ensure that unit pricing practice is consistent with the statements made about that practice in the life insurance policy, managed investment scheme constitution, superannuation trust deed, scheme compliance plan and the product disclosure statement.

5. Unit pricing entities must comply with their obligations

Product providers must comply with a range of obligations. For example, product providers have obligations to prevent unit pricing errors and to treat unit holders equitably. Product providers also have a duty to act in the best interests of unit holders as a whole. In meeting these obligations, and in the conduct of their business in relation to unit pricing it is likely that product providers will need to exercise judgement.

Proposed guidance: Product providers should use soundly-based processes when forming such judgements. Where assumptions are used in exercising judgement, those assumptions should be reasonable. Processes and assumptions, and the bases for those assumptions need to be documented.

6. Unit pricing entities are responsible for outsourced functions

Whether product providers perform functions in-house, or outsource unit pricing functions to a service provider, product providers remain responsible for the performance of those functions.

Proposed guidance: To monitor the provision of services by another entity, product providers should build and maintain an effective working relationship with the service provider, maintain appropriate knowledge, and build and maintain appropriate monitoring systems.

7. Unit pricing policies should be applied consistently and kept up to date

Many facets of business operations affect unit pricing, including product development, tax, accounting, information technology, legal, marketing and risk management. During the joint review the regulators found that the same unit pricing word or phrase can have different meanings even within one organisation.

Proposed guidance: Up to date policies are required to ensure that all relevant matters are addressed in unit pricing and that all business operational areas work together effectively. Policies should be discussed, understood and applied consistently.

8. Reasonable allowance should be made for the value of all assets and liabilities attributable to unit holders, including non-marketable assets and future tax assets and liabilities

In many cases the value of an asset can be readily and reliably determined from the quoted prices of similar assets that are regularly traded in a deep and liquid market. However, the value of some assets, including private equities, properties, and international investments may need to be estimated for a period until a firmer valuation becomes available or the asset is sold.

The same applies to tax assets or liabilities, the value of which depends on a range of assumptions about the amount and timing of future cash flows.

Proposed guidance: If updated values of assets and liabilities are not available at the time that a unit price is to be determined, then the value needs to be estimated on a reasonable basis that ensures that all unit holders, and potential unit holders, are treated equitably.

9. The value of an asset or liability for unit pricing purposes may not necessarily be the same as its value in the published accounts.

The purpose of the provider's accounts is to provide a true and fair indication of the financial position and performance of the provider. The value of assets and liabilities reported for that purpose may not necessarily be the same as that needed for unit pricing, where the priority is to ensure that unit holders are treated equitably.

Proposed guidance: Any differences between published unit prices and the corresponding assets and liabilities in the provider's accounts need to be able to be reconciled and explained to investors.

10. Errors need to be compensated

Errors may still occur. However, by diligent focus on risk management and control of systems and processes, the size and frequency of errors can be minimised.

Proposed guidance: If a material error is identified then all affected unit holders need to be compensated in a manner that is fair to all unit holders, whether affected or not. The threshold test for compensation needs to be applied consistently in each instance and in good faith.

What is unitisation

Unitisation is a way to equitably attribute a share of the value of invested assets to people holding units. Products that may be unitised include superannuation, life insurance and managed funds.

To enable people to enter or exit a unitised fund, the price per unit is determined based on the number of units issued and the value of fund investments at the time the price is calculated. Unit prices are generally calculated daily, weekly or monthly. The elements of a unit price calculation are shown in the diagram below.

UNIT PRICE
CALCULATION SYSTEM

- Calculate assets
- Calculate liabilities
- Calculate net assets
- Divide by number of units and take account of transaction costs to determine unit price

Another method to attribute a share of the value of invested assets is the use of a crediting rate. An amount is credited to each person's account based on the overall rate of return on fund investments and the amount invested by each person in the fund. A crediting rate is generally calculated monthly, quarterly or annually.

Unitisation provides a more direct link to movements in asset values, investment income and transaction costs, as unit prices are calculated at the time unit holders acquire or dispose of products. Unit pricing avoids any transfer of returns between generations of unit holders. That is, unitisation may be perceived as resulting in more equitable treatment of beneficiaries and fund members.

It is noted, however, that calculation of unit prices can involve significant administrative effort, and the costs of establishing and operating an efficient unit pricing system may be prohibitive for certain types of fund.

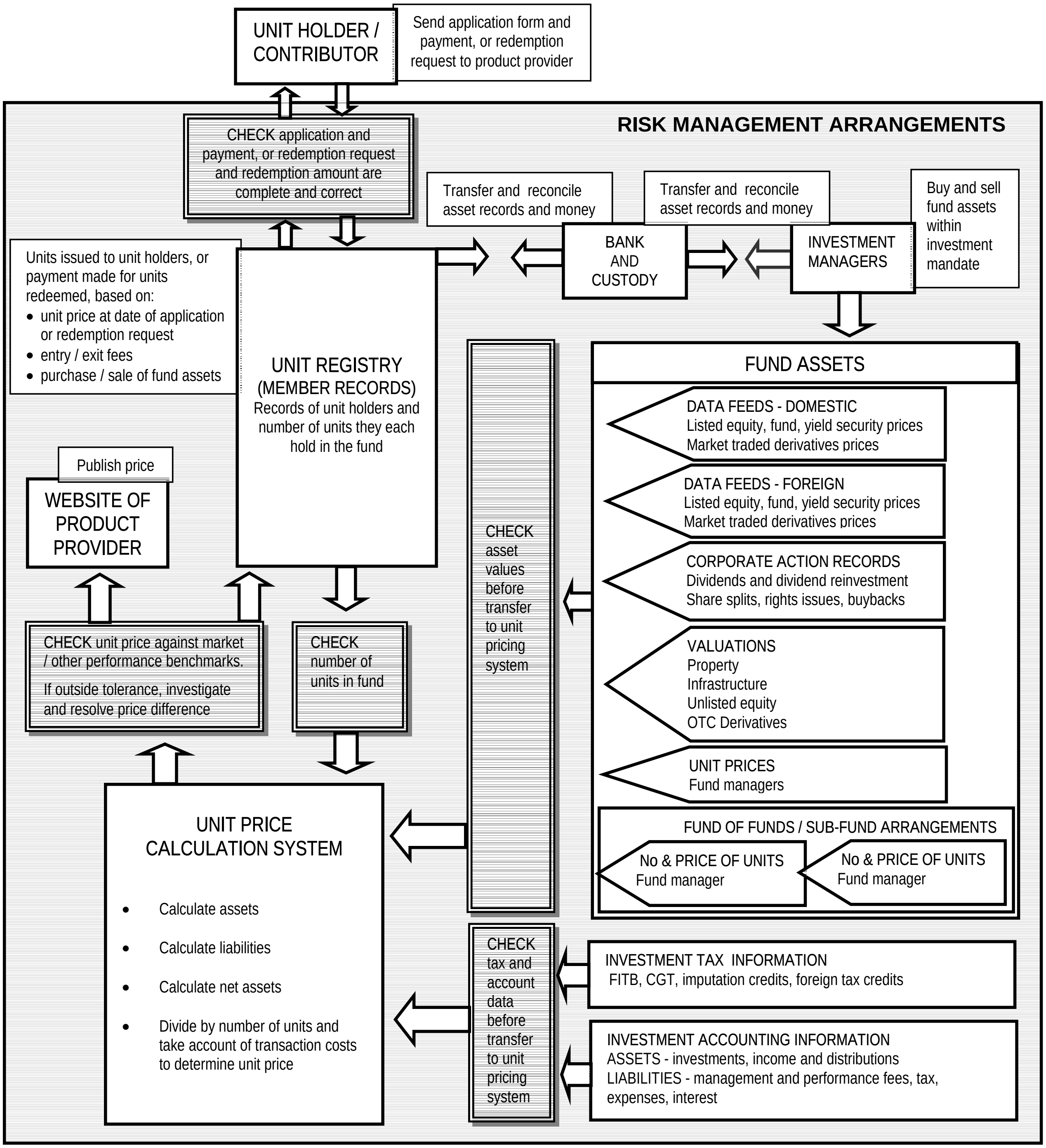
It is also noted that unit prices fluctuate with changes in asset values and investment returns. Where unit prices are calculated frequently there may be an appearance of greater volatility in fund value.

Whichever method is chosen – unit pricing or crediting rates - providers of superannuation and life products and managed funds should ensure that their practices provide fair and reasonable outcomes for all beneficiaries and members.

A number of the issues discussed in this consultation paper are relevant in the crediting rate environment. However this paper focuses on unit pricing issues and practices.

The following diagram outlines key elements and relationships in the unit pricing calculation cycle. While the small diagram above focuses on the unit pricing calculation itself, the larger diagram below illustrates the complexity of the overall unit pricing function, and shows the unit pricing calculation in this context, at the bottom left hand side of the page.

Key elements of unit pricing cycle



Some product providers may configure the elements differently. Some may use additional elements. All providers should undertake reconciliations, for example reconciling bank records and investment accounting records.

A product provider may choose to outsource some of the above functions. Nevertheless the product provider remains responsible for proper performance of outsourced functions and should retain the capacity to monitor and supervise service providers.

As there are many interdependent elements in a unit pricing system, where change is made to some elements, care should be taken to ensure that the system as a whole continues to operate effectively.

Management issues

Effective risk management culture

Risk in unit priced products

Unit pricing, like other business activities, involves risk. The number of steps in the unit pricing process and the complexity of the associated functions make the risk of pricing errors one of the most significant non-market risks faced by investors in unit-priced products.

These errors do not appear to follow a normal distribution. There are many trivial errors. However, when larger errors do arise, they tend to be very large indeed – there have been instances of errors greater than $10 million. The associated costs of rectification can also be substantial.

The unit pricing survey indicated that the greatest risks are seen to arise from:

- the timeframes in which unit prices need to be calculated
- taxation – including reconciliations of deferred and current tax, and determining values for current tax, deferred tax, and deferred tax assets
- lack of IT systems integration, and the need for manual workarounds
- managing the relationship between the outsourcing entity and the service provider
- legacy products and services – for life companies and some fund managers
- timely provision of information by external fund managers.

Attitude to risk management

An organisation's attitude to risk management is the major determinant of the likelihood and impact of unit pricing errors. Significant errors have arisen, and have continued to operate undetected where the approach to risk management has been inadequate. In the most egregious cases there has been failure even to identify the risk that errors might occur.

Effectiveness of risk management culture can influence the probability and impact of unit pricing errors more strongly than:

- the nature of the product – life insurance, superannuation or managed investment scheme
- the type of product provider – for example, life company, bank subsidiary, superannuation trustee, conglomerate

- the ownership structure, or the size of the product provider.

The effectiveness of risk management in the unit pricing function can indicate the effectiveness of risk management in the organisation as a whole. Organisations with unit pricing problems often fail to address other operational risks.

Seeking a proximate cause of a unit pricing error may not identify the actual cause. Frequently the problem is a failure to appropriately consider and manage risks such as:

- difficulties in asset valuation
- ineffective product management
- lack of effective control environment
- lack of an appropriate policy framework for fees, tax, asset valuation and other elements of unit pricing
- failure in information technology systems
- failure to manage outsourced services
- low priority for unit pricing resourcing, including number and seniority of unit pricing staff
- staff morale and productivity issues, including inadequate training
- ineffective project or transition management.

Role of senior management in establishing risk management culture

The board and senior management set the standard. If they demonstrate interest by setting policy and monitoring performance, high priority will be given to risk management throughout the organisation. A range of incentives and penalties may be applied, for example, linking risk management performance to budget.

However, if senior management indicates that risk management is of subsidiary importance, this attitude also will be reflected throughout the organisation.

Unit pricing errors occur most frequently in an environment of management indifference to the unit pricing function or to risk management generally.

Key considerations for managing risks in unit pricing

- How can systems and procedures be built and maintained to avoid errors? The risk of very large errors should be eliminated.

- How can errors be detected as soon as possible?

Effective detection controls are fundamental. A major determinant of the impact of a unit pricing incident is the time taken to identify the error.

- How can the time to address errors be minimised?

A key element of proactive risk management is effective planning, which includes the establishment and periodic review of procedures to quarantine, quantify and rectify errors as soon as they have been identified.

- How can independent oversight be achieved?

Internal and external audit reports should be taken seriously, and audit recommendations considered and implemented. The failure or refusal to implement audit recommendations is a clear indication of poor attitude to risk management.

In the risk management plans provided to APRA as a part of the superannuation licensing process, superannuation trustees need to identify, monitor and manage risks such as those inherent in unit pricing. Similarly, entities applying to ASIC for an Australian financial services licence need to address such risks in their risk management plans.

Accountability for managing risks

Unit holders expect exposure to the risk that investments may perform poorly. However unit holders should not be exposed to the risk of administrative error.

You are responsible to manage the risk of administrative error whether you invest directly in the market or through other product providers, for example by investing in managed funds. You should select product providers who themselves manage administrative risks effectively.

Unit holders reasonably expect that, regardless of where an error occurs in an investment chain, the initial product provider will take responsibility for managing risk, and for explaining and correcting the results of any errors.

On the alert

The following types of risk management issue may arise, based on what we have seen. This is not an exhaustive list of issues.

Unit pricing may receive little ongoing review or attention until a major problem is identified.

Reports, including senior management reports, may not focus on key unit pricing measures, or show the cumulative impact of issues arising in different parts of the organisation.

We are aware of cases where staff may be disadvantaged or penalised for reporting problems.

Symptoms may be addressed without identifying underlying causes. If piecemeal solutions are implemented, an organisation may continually incur costs of rework, investigation and compensation.

Well-defined communication channels and sign off procedures may not be established between different unit pricing functions.

There is a risk that skilled unit pricing staff will be taken away from business as usual to fix unit pricing problems. This may create even more exposure to unit pricing problems. The risk to ongoing business operations needs to be managed.

There is a risk that policies for unit pricing functions, including tax, accounting and valuation, application of transaction costs and fees, business continuity, disaster recovery and error rectification and compensation are incomplete or out of date.

Lack of detection of unit pricing errors can be a sign of insufficient reconciliations or checking.

Proposed guidance for good practice

Build and maintain an effective risk management culture

The need for effective risk management culture is a continuing theme of this guidance.

Senior management cannot be expected to understand every process at a detailed level. Nevertheless senior management are expected to have sufficient understanding of business processes, including unit pricing, to plan for and manage risks appropriately.

Depending on the nature, scale and complexity of the business, risk management systems and procedures are likely to include:

- Clear delegations and accountabilities
- Formal identification, assessment and rating of risks
- Formal identification of mitigating factors, with assessment and rating of their effectiveness
- Assessment and rating of the residual risk after mitigation
- Assessment of proposed changes in business activity that affect unit pricing
- Formal procedures to report on the above
- Senior management involvement in compliance and risk management. For example, this may include leadership of risk management and compliance committees and regular reporting to the board on risk issues

- The presence of a risk management unit and/or a compliance unit that monitors and advises on risk mitigation across the organisation

- The use of independent review, which may include internal and external audit, and the use of external consultants.

In particular, risk management for unit pricing should include:

- Senior management attention – the lower the profile of unit pricing, the higher the risk that errors will arise or continue undetected

- Attention to resourcing in each budget cycle for unit pricing staff, information technology systems and policy and procedures. The strength of the risk management culture is reflected in the priority senior management give to resources for unit pricing

- Support and encouragement for staff to report incidents and exceptions

- Implementation of operational procedures such as reconciliations in each pricing cycle. Inconsistencies may indicate errors and should be investigated and resolved as soon as possible

- Reporting of operational losses due to poor risk management

- Procedures to track errors and their resolution

- Periodic centralised review of incident and exception logs to identify systemic problems for further attention

- Involvement of unit pricing staff in the design of information technology testing for changes to unit pricing systems.

These lists are not intended to be exhaustive. Product providers are responsible to ensure they identify, measure, mitigate and manage business risks.

Further guidance is provided in the Australia/New Zealand standard on risk management AS/NZS 4360:2004. For Australian Financial Service licensees, PS 164 Licensing: Organisational capacities provides guidance at paras .105 to .119 and .138C. Further guidance is provided for responsible entities in PS 132 Managed investments: Compliance plans.

Training

Staff need training to understand the end-to-end unit pricing process and how their own responsibilities fit in that process. Errors should not arise because "things fall between the cracks". Training is essential for the effective implementation of procedures.

Some industry participants have commented that, as indicated by process improvement methodologies, the development of process maps by unit pricing staff is itself a very effective training tool.

While policy may be developed separately from operational areas, procedures reflecting that policy should be developed in consultation with unit pricing staff. This also may be an effective training tool.

Documented policies and procedures

Documentation promotes efficiency and consistency, and also manages risk by:

- Reducing reliance on key individuals
- Describing checks, clear paths for investigation of errors and reporting/escalation procedures
- Providing clear instructions for events requiring complaints management, disaster recovery and business continuity. The risk of "spur of the moment" decisions is reduced
- Providing clarity about the authority to exercise discretion
- Providing clarity about the meanings of terms – for example tolerance thresholds may be specified rather than referring to "material amounts"
- Outlining each step/process, its purpose and the recipients of each output
- Specifying requirements for review or senior staff decisions
- Describing the evidence of review, such as a signed printout, required for each step/process

Documentation should be periodically reviewed and updated. Effective documentation does not need to be voluminous.

Documentation does not replace individual vigilance.

Independent review and investigation

Such review can be provided by a party not directly involved in the unit pricing function and may include review by internal audit, the compliance unit, the risk management unit, external auditors, or by other external advisers.

Regular independent review of the inputs and outputs of unit pricing, as well as the related systems, procedures, methodologies and controls, can significantly reduce the risk of error. These reviews should both check accuracy and consider whether the related processes continue to be relevant.

The unit pricing survey found that, where entities conduct audits, they tend to conduct audits for unit pricing functions including member registry, fund accounting, asset valuation, and fee, tax and unit price calculations.

However, member registry and tax calculations are audited less frequently. While external audits are generally conducted half yearly or annually, internal audits tend to be based on the organisation's assessment of risk.

The use of such independent review is generally regarded as good practice. For example, IFSA Standard 5.00 "Operational Capabilities" specifies that scheme operators should have appropriate compliance or independent audit functions to ensure that control systems operate effectively.

It is also noted that the compliance plans of registered managed investment schemes must be externally audited every financial year (section 601HG of the Corporations Act 2001).

Your comments

Q1 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q2 Do the proposals above raise other issues that also require consideration?

Q3 The proposals above require a high degree of integration in the risk management and risk reporting systems. What constraints might limit the development of such integrated systems?

Unit pricing issues common to many products

Forward pricing or historic pricing

With forward pricing, applications to buy or sell units are processed using a price calculated and published after the applications have been received. For example, the end of day price is used for applications received during that day.

The alternative is to enable purchases and sales of units using a price calculated before applications have been received (backward or historic pricing). For example, yesterday's price is used for applications received today. In this case the most recent market movements are not reflected in the price. People can buy or sell units to take advantage of the difference between yesterday's price and the subsequent shift in market value.

ASIC's recent review of investment practices amongst 70 fund managers in Australia (following regulatory action regarding market timing and late trading behaviour in the USA) showed that 84% of fund managers used forward pricing exclusively while 9% used some backward pricing.

Many pieces of information are used to calculate one unit price

As shown in the diagram of key elements of the unit pricing cycle, data is drawn from many sources to calculate a unit price. For example, information about security and derivative values, foreign exchange rates, or tax benefits and fees might be included in a price. The greater the number of pieces of information, the greater is the likelihood of error.

Transaction costs

When unit holders enter or exit an open-ended fund, investment assets are bought or sold to support the change in number of units on issue. The acquisition or disposal of these assets incurs transaction costs such as brokerage fees.

These transaction costs will vary depending on the types and volumes of assets transacted. A fund investing in international equities will incur transaction costs different to a fund investing in domestic fixed interest securities. Funds with high volumes of transactions may be able to negotiate lower brokerage fee rates. In some cases, for example when a person invests in a fund by transferring equities into the fund ("in specie" transfer), transaction costs are not charged as brokerage costs have not been incurred.

There are a number of ways that transaction costs can be allocated.

The mid-price is a single price used for both sales and purchases. Transaction costs for unit holders entering and leaving the fund are paid by the fund and so subsidised by all existing unit holders. The impact on the fund becomes greater as more units are bought and sold.

With a buy-sell spread, two prices are applied, calculated from the mid-price plus or minus an allowance for transaction costs. The higher price is paid by people entering the fund. The lower price is received by people exiting the fund.

With the net buyer/seller method, a single price is used for both applications and redemptions. Whether the price is above or below the mid-price depends on whether there are more buyers or sellers.

- When the overall size of the fund is increasing – a net buyer position - transaction costs are added to the unit price. In effect the underlying assets associated with the units of exiting unit holders are sold to the new unit holders.
- When the overall size of the fund is decreasing - a net seller position - transaction costs are subtracted from the unit price.

Backdating procedures

Fund documents generally specify rules for the unit price to be applied when units are issued or redeemed. Applications to buy and sell units should be date stamped so that the appropriate unit price can be applied to transactions, even if, for administrative reasons, the units cannot be issued or redeemed on the specified date.

There may be delays in issuing or redeeming units or processing switches, for example, where an unusually high volume of applications is received on one day, or where all the required information is not received at one time. This may be the case, for example, for superannuation funds where employers make contributions well in advance of the employee records being received by the fund.

In some cases, money received in advance of unit holder details is invested in the fund (although these assets are not counted in the unit price until units are issued). In other cases, unprocessed money is held in an interest bearing account until the units are issued, when the interest is allocated to the new unit holders. (Refer to s1017E of the Corporations Act 2001.)

Depending on the circumstances of the fund, it may be possible in some cases not to accept applications until all the necessary information is provided and accompanied by payment for the correct amount.

Manual systems and workarounds

Some entities use computer spreadsheets to calculate and record pricing data or unit prices. Some entities, particularly where there have been takeovers or mergers, join disparate unit pricing computer systems using temporary manual systems that are not well documented or maintained, but which become entrenched over time.

On the alert

The following types of issue may arise, based on what we have seen. This is not an exhaustive list of issues.

Forward pricing or historic pricing

We have seen instances of fund documents stating that only forward prices would be used, whereas, incorrectly both forward and historic prices have been used in practice.

There is potential for arbitrage where historic prices are used. This would benefit a few transacting unit holders, to the detriment of all ongoing unit holders.

Many pieces of information are used to calculate one unit price

Commercial data feeds for listed equity and derivative prices may include stale prices, zero amounts, or daily movements outside the usually accepted tolerances.

External fund managers may be slow to provide the prices of units in unlisted managed investment schemes. Managers vary in their ability to provide prices, depending on their technology and systems. The wrong data files may be sent, or data files with the wrong date may be used in unit pricing calculations.

We have seen incorrect foreign exchange and fee rates applied.

Prices may be provided by facsimile, rather than electronically, and require manual entry. Manual operations increase the possibility of error.

Transaction costs

We have seen errors arise where uncertainty about the appropriate methodology has resulted in inconsistent calculation of transaction costs and inconsistent application of transaction cost amounts.

Backdating procedures

Unit pricing errors can arise where the appropriate unit price is not applied, due to administrative error in recording the date of receipt, or in applying the unit price for the wrong date. This may occur particularly when there are long delays before processing or where many applications accumulate.

Manual systems and workarounds

We have seen stale asset values keyed into manual systems, as well as the use of incorrect rates or incorrect formulae for fees, and double counting of fees.

Proposed guidance for good practice

Forward pricing or historic pricing

Forward pricing is preferred to historic pricing. You should take steps to move to forward pricing, where possible.

Historic pricing is not preferred. Where historic pricing is used, controls should be in place to avoid arbitrage. Some controls that may assist are:

- use of switching fees, to make arbitrage uneconomic
- monitoring and investigation of switching activity by investors
- market volatility tests so that unit transactions are suspended if markets move by more than a pre-determined amount. This should be supported by clauses in the documents that set out fund operating rules, to permit suspension and recalculation of unit prices during periods of extreme market volatility.

Many pieces of information are used to calculate one unit price

You should have systems and procedures to check that data has not become unreliable, inaccurate or late. It is essential that each data item used in a unit pricing cycle be appropriately checked before it is fed into the unit pricing calculation.

Training should be provided. The unit pricing team should understand the check for each data item and the importance of undertaking each check.

Unit pricing entities need to develop and consistently apply policy and procedures to deal with situations where information is unexpectedly not available, for example due to computer failure or loss of data feeds.

Transaction costs

People buying and selling units in the fund need to pay an allowance for transaction costs, to the extent that transaction costs are incurred.

Transaction costs should be calculated and applied consistently and equitably. Application of transaction costs should not result in money accruing to the fund manager. Where there are investment options within a fund, to the extent possible any benefits arising from transaction costs should be retained within each option.

The transaction cost methodology needs to be appropriate for the nature of the fund, documented, understood and periodically reviewed.

Backdating procedures

For each application, redemption or switch request, you should record the date of receipt, the date of processing and the price used to issue units on that date.

You must ensure units are issued and redeemed at the price stated in the governing documents, even when, due to unavoidable administrative delays, the actual issue or redemption of units occurs at a later date.

To the extent possible, procedures should be designed and resources provided to avoid delays and to remove the use of backdating. Ensure appropriate numbers of administration staff are available.

You need procedures to enable reprocessing where units have been issued at the wrong price and an adjustment is required.

There may be substantial market movements between the date of receipt of the application and the date when the units are issued or redeemed We would normally expect the fund manager to be the source to fund this difference. Where an entity has no external source of funds, in the case of a non-profit superannuation fund without reserves, ongoing unit holders may need to fund the difference.

Manual systems and workarounds

Short-term computer fixes and manual workarounds have been a significant cause of unit pricing errors and should be avoided.

In the short term, controls and independent reviews need to be implemented to manage these systems.

In the longer term manual systems and workarounds need to be replaced with automated processes.

Your comments

Q4 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q5 Do the proposals above raise other issues that also require consideration?

Q6 What constraints might limit the movement to forward pricing for all products?

Q7 What constraints might prevent the elimination of backdating?

Q8 What constraints might limit allowing for transaction costs in all unit prices.

Additional unit pricing issues for products with complex structures

Greater care is required to calculate unit prices where products have additional features that affect the timing or the complexity of the unit pricing calculation.

Fund of fund structures

A fund manager may invest in other funds, rather than investing directly in products such as equities, fixed interest securities or derivatives. These other funds may be managed by the same corporate group, or by independent asset managers.

In a fund of funds structure, there are layers of unit pricing calculations. The fund manager needs to be confident that the units of the sub-funds are appropriately priced before using those prices as asset values to calculate the unit price for the higher level fund.

Investments between retail and wholesale funds

Management of assets in retail funds often involves investment in larger unitised wholesale funds, with other retail and wholesale investors, to access the expertise of particular professional investment managers and to obtain the benefit of lower fees.

As in fund of funds structures, the retail fund manager needs to be confident that the units of the wholesale fund are appropriately priced before using those prices as asset values to calculate the unit price for the retail fund.

Options within a fund

There may be several investment options within one fund. Each option may treat differently items such as taxes, fees and distributions. These differences should be taken into account when calculating unit price.

Performance fees

Traditionally fees are management fees that are paid according to the amount of funds under management (FUM). Where FUM increases, managers earn more fees.

More recently, performance fees have been applied in some funds in addition to management fees. For example, some managers are deciding that an investment strategy cannot continue to perform at the same rate where FUM increases beyond a certain level. Where FUM ceases to grow the potential to earn traditional management fees is also capped.

In this case, performance fees provide ongoing potential to earn higher fees.

Performance fees are structured in many different ways. They often require complex calculations including thresholds, rates and accruals.

International assets

Where funds invest in international assets, there may be delays in confirming acquisition or disposal of those assets and in obtaining asset values and exchange rates.

On the alert

The following is an indication of the types of issues that may arise for products with complex structures, based on what we have seen. It is not intended to be an exhaustive list of issues.

Fund of fund structures

There have been cases where fees have been inappropriately "double charged", for the fund as well as the sub-fund. There have also been cases where the amounts of fees charged have not matched the amounts of fees described in fund documents.

Investments between retail and wholesale funds

There have been instances where fees, distributions, taxes and allowances have been applied without regard for the different rates that apply to retail and wholesale products.

International assets

Decisions have been made to include in investment mandates new or unusual international assets, before the fund manager has ensured that the required reliable asset values can be obtained by the unit pricing team in time for unit price calculations.

Performance fees

Models for performance fee calculations are usually individually designed and often complex. There is also complexity in incorporating the fees calculated from these models in the unit price. The greater the complexity, the more likely is error to arise in mechanisms to deal with negative performance, descriptions of benchmarks, fee calculations and accrual of fees between performance measurement points.

Proposed guidance for good practice

Extra layers of complexity require greater commitment to develop effective systems and procedures.

You should build into your unit pricing cycle an allowance for the time needed to obtain unit prices from external fund managers and to obtain international asset values. Unit pricing can only move at the pace of the slowest determination of this information.

You should review the operations of other fund managers to understand and develop confidence in their unit pricing practices.

You should build the unit pricing calculation system to adjust for the taxation, fee, distribution and other features of sub funds and wholesale funds. Periodically review the documentation of sub funds and wholesale funds to ensure the correct adjustments are made. The development and operation of complex systems often benefit from independent expert review.

For complex calculation of performance fees, the model, its operation and its relationship with the unit price calculation need independent expert review.

Your comments

Q9 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q10 Do the proposals above raise other issues that also require consideration?

Q11 What difficulties might arise in obtaining timely asset values, and how might these difficulties be overcome?

Q12 It appears that an increasing number of fund managers are using performance fees. Frequent incorporation of performance fees in unit prices may present challenges. What difficulties might arise in accruing performance fees within the performance fee period, and in factoring these fees into the unit price? How might any such difficulties be overcome?

Managing diversity in systems and products

Large entities with a history of acquisition are more likely to operate a diverse range of systems and products.

The greater the diversity, the more care is required to calculate unit prices. Prior regulatory review has found that the incidence of error is higher where there are many products operating under different rules or several administration platforms being operated at once.

Diversity may be present in:

- the age of products and their associated documents and administration systems
- the number of product types – life insurance, superannuation, managed funds
- the frequency of unit pricing for these products
- the assets in which the funds invest, and associated valuation methods
- the information technology systems used for unit pricing.

On the alert

The following is an indication of the types of issues that may arise, based on what we have seen. It is not intended to be an exhaustive list.

Age of products and systems

The unit pricing survey found that life companies and some fund managers have a substantial proportion of products and systems more than 10 years old.

Such legacy products may not be intrinsically prone to error. However the systems on which they depend may not process data quickly and may not interface well with modern data sources or other systems. For some legacy products there are manual workarounds that may be undocumented.

Products closed to new clients do not provide substantial sources of new revenue. Funds may not be allocated to upgrade the systems and procedures associated with these products. In some cases it may be very difficult to integrate these systems with newer technology. Documentation may be out-of-date. System support may be limited. The operation of the systems may rely on the knowledge of a few key personnel.

Range of product types

The operating rules, record-keeping requirements and compliance obligations are different for life insurance, superannuation and managed fund products. This diversity increases the complexity of maintaining associated systems, procedures and controls.

Frequency of unit pricing

Administrative complexity increases with the number of different unit pricing cycles – daily, weekly, monthly. Misunderstandings may arise about the relevant values for assets, liabilities and taxation amounts.

Assets in which the funds invest

The wider the range of assets, the more complex is the task of obtaining timely and reliable asset values. Refer to the section "Determining asset values".

Information technology systems

The greater the number of systems, the greater is the cost to maintain and modify those systems. Diversity prevents the application of standard solutions for development, testing and rectification.

Where there are different products as well as different systems, maintenance becomes particularly difficult. Products are affected differently by market and regulatory change, and require individually tailored system modifications.

Proposed guidance for good practice

Complexity is expensive. Simplification, where it can be achieved, will assist good practice.

Assess the risks of diversity and implement appropriate risk management strategies. Refer to "Effective risk management culture".

Documentation should be clear, complete, and up-to-date. Documentation should include checklists, and this documentation should be used. Products, systems and procedures should operate without relying on the knowledge of particular individuals.

Age of products and systems

It may not be feasible to replace old products or systems. Additional care and attention are required to management old products and systems effectively.

Products and systems that are new today will be legacy products or systems in a few years. Ongoing review and improvements are required to keep pace with market and regulatory change.

Reconciliations, in addition to vigilance and a strong control framework, can assist in managing diverse systems.

Range of product types

Clearly distinguish procedures for different product types in your documentation. Unit pricing staff may assist in the development and testing of these procedures.

Frequency of unit pricing

Establish clear procedures for each pricing cycle. Unit pricing staff may assist in the development and testing of these procedures.

Information technology systems

Maintain the capacity to operate systems effectively. Plan to upgrade.

Your comments

Q13 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q14 Do the proposals above raise other issues that also require consideration?

Q15 What constraints might limit the ability to keep documentation up-to-date?

Q16 What are the major constraints of legacy systems and products that might limit compliance with this guidance and how might these limitations be addressed?

Managing change

Change that might appear initially to be unrelated to unit pricing can significantly affect the unit pricing function.

Particular attention is required where there is change in regulation, tax and accounting requirements, organisational strategy or structure, high staff turnover, change in outsourcing arrangements, change in product offerings or change in information technology systems.

Prior regulatory review has noted that an additional risk may arise where there are many changes at one time. The internal environment becomes unstable. Management and staff may become distracted.

On the alert

The following types of change management issues may arise, based on what we have seen. This is not intended to be an exhaustive list of issues.

Change in strategy and structure

A takeover or merger, or the appointment of a new board or senior management is likely to lead to significant change that may affect unit pricing.

- Altered reporting lines or systems may affect the information available to senior and middle management.
- People in teams may be dispersed to other work groups, made redundant or be geographically relocated, which may affect morale or operational effectiveness.
- Staff with key knowledge may leave the organisation.
- Based on new strategy, or the need to obtain planned economies of scale, products, services or procedures may be changed without first building a firm understanding of the impact of that change.
- When companies and their products are acquired, unit pricing problems may also be acquired.
- When two entities merge there may be cultural differences. People in one unit pricing area may not communicate effectively with people in another unit pricing area or with people in investment accounting, tax, registry, custody or investment management areas.

Reliance on short term staff

Some operational areas may provide limited opportunities for career progression. This may lead to long term reliance on short term contract staff.

Change in outsourcing arrangements

When an entity decides to outsource unit pricing functions, or decides to change from one service provider to another, extra attention and resources are needed to ensure all relevant issues are addressed.

See further discussion in the section "Outsourcing unit pricing functions".

Change in product offerings

Product change has occurred with greater frequency in recent years, to meet customer demand. As noted above, products may be introduced, changed or closed before the consequences are understood. For example:

- Product change might require change to documents such as scheme constitutions, product disclosure statements, or superannuation trust deeds
- Unit pricing systems may not be able to support product design changes such as:
  - Investment in funds rather than direct investment in securities – with the associated increased complexity for tax and fee arrangements
  - Investment in assets that are difficult to value
  - Change to fee arrangements, including introduction of management or performance fees or fee rebates

Change to information technology systems

Maintenance or system upgrades may not be fully tested or appropriately reviewed.

Documentation may not provide a reliable base for system development.

Integration risk

Where many changes or projects occur in combination, the usual checks and reconciliations may not take place. Risks may not be apparent and unit pricing problems may emerge undetected.

Proposed guidance for good practice

Develop change management processes that include unit pricing issues and involve unit pricing staff.

Provide training and implement a communication strategy so that staff understand the extent and effect of changes.

- Advise implementation timeframes and the reasons for any change in those timeframes

- Provide forums for feedback – consider obtaining the benefit of constructive staff suggestions to manage change.

Your risk management strategies should address change management. Procedures are required to identify and address unit pricing errors arising during change.

Change in strategy and structure

Reports should be designed so that significant unit pricing issues can be identified, no matter where they arise in the organisation.

Staff morale and key person risk need to be addressed.

The consequences of product and service change need to be considered before change is implemented.

The control environment, including controls for unit pricing operations, needs to be assessed as a part of considering potential acquisitions.

A strong customer service focus can assist in directing attention, and giving priority to the operation of effective administration systems and procedures.

Pressure to downsize should be balanced with the need to provide effective service and the need to comply with obligations.

Reliance on short term staff

Effective supervision and training, and the use of reliable documentation are required where there is high staff turnover. It may also be appropriate to consider ways to reduce staff turnover.

Change in product offerings

When making changes to products, strong communication channels are required to ensure comprehension of the issues and consistency in approach. The product development, change management, risk management, legal, marketing, tax, accounting, information technology and unit pricing teams need to understand each other's language, timing and processes.

Changes need to be considered for the legal documents describing products, as well as the changes to the systems and procedures relating to the management of those products.

Change to information technology systems

You need protocols to manage information technology system change.

Operational staff who understand unit pricing procedures need to sign-off the test plans.

The test scripts should deal with infrequent events, such as end of financial year, and unusual circumstances, such as price suspension.

The test data should cover the valid range as well as the invalid range, to force errors.

The old and new systems usually need to run in parallel for at least one business cycle.

Integration risk

Create an overall framework for change management. Highly effective reporting and co-ordination are required to understand and manage the effects of change on other change, and the effects of change on ongoing operations.

Your comments

Q17 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q18 Do the proposals above raise other issues that also require consideration?

Q19 What are the limits in developing processes to understand the effects of change before that change is implemented?

Outsourcing unit pricing functions

In financial services globally, the use of outsourcing to both related and unrelated entities appears to be increasing. Performance of business activities by service providers has attracted the attention of international standard setters who are developing principles of good practice for outsourcing.

Responsibility for outsourced functions

Accountability for the performance of business activities, whether outsourced or not, remains with the product provider. The risk of non-performance does not transfer to the service provider when a business activity is outsourced.

The product provider should retain sufficient knowledge of the outsourced functions to effectively monitor the performance of the service provider, address any deficiencies in performance, and ensure continued compliance with all regulatory requirements.

The product provider is also responsible to maintain up-to-date knowledge of regulatory obligations.

(Sections 601FB and 769B of the Corporations Act and subsection 52(2) of the Superannuation Industry (Supervision) Act 1993(SIS))

Outsourcing for unit pricing

In Australia a number of entities contract with service providers to perform unit pricing functions. The unit pricing survey found that such outsourcing entities appear to make a decision either to outsource very few, or to outsource the majority of unit pricing functions.

Where outsourcing is used for unit pricing, business activities are more likely to be outsourced to an unrelated entity than to an entity within the corporate group.

The functions most commonly outsourced are asset valuation and fund accounting. Superannuation providers generally outsource more than life companies and fund managers and, in particular, tend to outsource the calculation of unit prices and tax amounts.

On the alert

We have seen the following types of issue arise in outsourcing. This is not an exhaustive list of issues.

Effective communication is essential in all phases of outsourcing

While the decision to outsource is clearly a determination for the board and senior management, work units may not have been consulted about the consequences of outsourcing and the key issues and risks to be managed during transition. Effective communication channels may not have been set up between work areas, or between work areas and the board. Discussion and planning for outsourcing take place under pressure - it is in addition to and should not compromise the effectiveness of business as usual communications about unit pricing.

When undertaking detailed review of possible service providers and later, when setting up a relationship with a particular service provider, entities may not have taken the time to clarify the nature and levels of services required. Commonly used expressions such as "soft pricing", "leverage" and "performance" can have particular meanings in different organisations. Up-to-date, accurate and detailed documentation of systems and procedures, including diagrams and process maps, can greatly assist your discussions with service providers. Key elements of the service provider's unit pricing methodology, processes and controls need to be understood.

The relationship with the service provider may not have been appropriately managed. During transition you will have specified the nature and frequency of reports to be provided. These regular reports need to be considered at senior and operational levels. Problems need to be escalated and addressed.

When changing service provider, three parties - the outsourcing entity, the current service provider and the proposed service provider – need to set up effective communication channels. When the number of entities increases, the complexity and the risks increase, and more time is required to communicate effectively. Details may be overlooked. The level of risk increases further where an outsourcing change occurs due to dissatisfaction with current levels of service provision.

Outsourcing affects staff morale and productivity

When you decide to outsource business activity, some staff know they will cease in their current roles in your organisation. It may be difficult to ensure that the people with greatest knowledge of critical business functions, including unit pricing, have appropriate support and incentives to work towards effective transfer of unit pricing functions to the service provider.

The impact of outsourcing on staff productivity may be greater when it occurs in the context of a takeover or business relocation.

Outsourcing is a long-term commitment

Choose a service provider carefully. Selection of an inappropriate service provider may lead to business disruption and damage your relationship with your clients and your reputation.

An effective transition to outsourced service provision may need to be implemented over a 6 to 12 month period. You need to work with the service provider using a project management methodology. Considerable costs are involved in this transition process.

Some industry participants have indicated that, to recover the costs of transition and gain the benefits of using a service provider, you need to think in terms of a three to five year commitment to outsourcing.

You should pay attention to the development of strong working relations, both in allocating resources to ongoing relationship management and in agreeing the contract for services. One entity or the other may propose their standard form of contract. You need to ensure that the contract meets your requirements. It is likely that the contract will need to be tailored to your circumstances. Considerations may include:

- Whether you write service level agreements (SLAs) into the contract, requiring legal involvement to effect change. As an alternative, service level agreements might be written in a separate document to which the contract makes reference.

  The majority of respondents to the unit pricing survey stated that they had SLAs in place for most outsourced functions. Some superannuation funds, however, did not have service level agreements in place.

- The extent to which it is feasible or necessary to customise standard services. The cost advantage of economies of scale will be lost to the extent that services are individually tailored to your requirements. On the other hand, there may be times where standard services need to be brought into step with emerging industry trends, or where there is no choice but to tailor services.

- The extent to which you require reporting on breaches of SLAs. The unit pricing survey found that a fifth of respondents do not have such reporting in place.

When drafting SLAs it may be appropriate to refer to other documentation such as procedure manuals and policies.

Proposed guidance for good practice

Develop and implement outsourcing policy and procedures

Determine which functions constitute your core business and which functions can be outsourced. Develop a detailed business case. Consult the people who are able to assess the risks, the costs and the benefits of outsourcing.

In addition to the board and senior management, and depending on the size and nature of your business, these people may include:

- Middle management
- The operational unit pricing team
- Risk management, compliance and internal auditors
- The product development team

- o The information technology team
- o The legal team
- o External asset advisors

Develop criteria to assess the capacity of service providers to meet your requirements. These criteria may include:

- Financial strength and technical abilities of the service provider
- Ability to understand the objectives of your organisation
- Nature of the relationship management arrangements, including project management during the transition and exit processes
- System and staff resources available for unit pricing – if the number of your investors increases, you may want to increase the number of products and so the number of prices, or the frequency of unit pricing – does the service provider have this capacity?
- Nature and frequency of reports and reviews you will receive
- Nature of risk management and compliance procedures, including internal and external audit
- Profile and resourcing for the risk management and compliance functions
- Extent of access, for you and your auditors, to the service provider's records
- How the service provider has managed past problems. Reference checks will assist your decision.

The unit pricing survey found that more than a third of outsourcing agreements do not include arrangements for dispute resolution.

The unit pricing survey also found that a quarter of entities do not have arrangements in place to exit outsourcing agreements.

You need to set these arrangements in place at the commencement of the relationship with the service provider, and review their effectiveness from time to time.

Manage the transition process

Agree the project management approach – develop procedures for escalation of issues and for decision-making.

Identify and manage staff morale and productivity.

Clarify with the service provider:

- the services to be outsourced and the linkages with functions to be retained in-house.

- Whether functions you retain need to be restructured. For example, some providers do not generally backdate transactions. They accept only complete applications and clearly identified payments. You may need to modify your arrangements with contributors to the fund.

- the extent of customisation of standard services. Substantial customisation may inhibit subsequent transfer to another service provider.

- Linkages with in-house business continuity and disaster recovery plans. Test for a range of unusual physical and market conditions and determine the extent of periodic testing required.

Negotiate the contract and service level agreements:

- The nature, frequency and quality of the services to be provided

- Standards required for sub-contractors

- Procedures for giving authorised instructions to the service provider

- Reports – do they include comparisons with performance benchmarks and notification of breaches of SLAs? Are some reports – such as compliance with investment mandates – prepared on an ad hoc basis?

- Frequency of reviewing SLAs

- Circumstances in which the contract can be terminated, and procedures for orderly transition

- Use of confidential information about the product provider's clients.

Audit the quality of your data before transfer of functions to the service provider.

Monitor the provision of outsourced services

The transition team and procedures may continue to operate for some time after the end of the transition to outsourcing. This enables the known escalation and problem solving procedures to continue during the early stages of the new relationship.

Ensure the agreed reports are provided and reviewed promptly at operational and senior levels of your organisation. Breaches of SLAs should be reported to you as soon as possible. The service provider should also refer such breaches to its risk management area as soon as possible.

Discuss issues with the service provider periodically. Depending on the nature and complexity of the business, it may be appropriate to conduct these reviews monthly, quarterly or half yearly.

You need to review your strategic direction periodically and discuss with the service provider your levels of satisfaction with the outsourcing arrangements. Service level agreements may need to be updated to match shifts in your strategy or the business environment.

Implement training in your organisation to maintain knowledge of both regulatory obligations and the outsourced functions.

Prudentially regulated entities need to ensure that APRA can conduct on-site reviews, and inspect documents and information held by the service provider.

Even though services are provided by other entities, outsourcing entities remain accountable for the quality of service provision to their unit holders.

Outsourcing entities also remain accountable for compliance with regulatory obligations.

Further information is available in APRA Superannuation guidance note SGN 130.1 Outsourcing, July 2004, in ASIC Policy Statement 164 Licensing: Organisational capacities, paragraphs .25 to .29 and Policy Statement 130 Managed investments: Licensing, paragraphs .36 and .56 to .59. Other useful information is set out in APRA Prudential Standard on Outsourcing APS 231 and attached Guidance Note AGN 231.1 Managing Outsourcing Arrangements,

Also relevant are the IOSCO report "Principles on Outsourcing of Financial Services for Market Intermediaries" and the Joint Forum "Outsourcing in Financial Services" dated 2 August 2004.

Your comments

Q20 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q21 Do the proposals above raise other issues that also require consideration?

Q22 Outline any difficulties you might encounter in meeting this guidance, and suggest how these difficulties might be addressed, particularly if outsourcing to entities outside Australia.

Technical issues

Determining asset values

Appropriate valuation of assets and any related liabilities is essential to the calculation of unit price.

Asset valuation issues include:

- The relationship between the frequency with which assets are valued and the frequency with which unit prices can be struck to enable purchase and sale of units
- The use of soft prices. These prices are estimates based, for example, on index or other market movements, when actual or hard prices are not available in time to strike the unit price
- Determining values where assets are not traded in deep, liquid and well-maintained markets but where there are recognized valuation methodologies. These methodologies are applied with varying frequency depending on market conditions and the professional judgement of investment managers and valuers. Such assets include property and infrastructure
- Determining values where assets are not traded in deep, liquid and well-maintained markets and valuation methodologies are less well recognized or are specific to a transaction. Such assets include some types of complex structured products and some types of OTC derivative
- Determining values where assets are traded in deep, liquid and well-maintained markets, but are traded only infrequently (thinly traded), for example rarely traded shares
- Determining values for illiquid assets. For example, some hedge funds are able to determine the value of unit prices only every quarter
- Understanding the age of valuations, including the date of data feeds, and the date of unit pricing by external fund managers
- Understanding the unit pricing methodology used by external fund managers – whether or not fees, fee rebates, transaction costs, tax, or distribution entitlements are included in unit prices
- Formulation and documentation of valuation policy for the range of assets held in the fund, and the development and implementation of associated procedures

On the alert

Following is an indication of the types of asset valuation issues that may arise, based on what we have seen. It is not intended to be an exhaustive list of issues.

The frequency of asset valuation and the frequency of striking unit prices

Daily prices may need to be struck, based on reasonable estimates, where the values of underlying assets cannot be determined on a daily basis. As noted above:

- Some hedge fund assets may be illiquid for long periods
- Some assets may be traded on deep, liquid and well-maintained markets, but have not traded for long periods. The last available price may not provide a reasonable measure of asset value
- Some assets, such as some OTC derivatives, are subject to private valuation arrangements
- Where there is reliance on periodic independent valuations – for example annual property valuations – a basis is needed to estimate an interim value.

Soft prices

Discrepancies may go undetected and errors in valuation may emerge.

- Estimates may not be checked with sufficient frequency against prices that have been calculated using up-to-date hard prices
- The checking process may be incomplete or explanations of differences may be incomplete
- The practice of soft pricing may encourage the use of inappropriate asset values. Values may be stale – well out-of-date

Overseas and domestic exchange-traded assets

Some funds include assets traded on both foreign and local markets. Reasonable policy needs to be set regarding the time at which the value of the foreign assets will be taken, as well as the time at which the associated exchange rates will be struck.

Adjustments to net present value calculations

Where the net present value methodology (NPV) is used to calculate a valuation, the period of time for which the asset is assumed to be held for NPV should be considered in relation to the hold-sell investment strategy of the fund. A methodology that assumes long term ownership of the asset should not be used if the asset is to be sold in the short term.

Proposed guidance for good practice

Soft pricing

You need to determine the appropriate frequency for calculation of hard prices, and for the comparison of hard and soft prices, based on the nature of the assets.

Determine a reasonable basis for adjusting prices when a significant difference is found. Document the basis, including an explanation of why it is reasonable, and the nature of any rectification action.

Document and monitor the use of valuation procedures

Document all valuation methodologies and procedures. Monitor and report on the use of these procedures.

Review and update these methodologies and procedures periodically, and as market conditions change. Obtain expert professional advice where necessary.

Document the delegation levels and processes to approve the use of valuations.

Resources

Ensure appropriate resources are available to support the valuation process for each type of asset.

Develop valuation policy for unit pricing

The asset valuation methods used for unit pricing calculations should be determined on a sound and justifiable basis.

Asset valuation policy should reflect the purpose for which asset values are determined - to determine the entitlements of unit holders, taking into account intergenerational equity for entering, ongoing and exiting unit holders.

This purpose is not necessarily the same as the purpose underlying asset valuation to prepare financial statements, although in many cases the asset values will be consistent. Some differences in value will arise due to timing differences or due to differences in valuation methodology. Such differences should be monitored, analysed and reconciled, at least on an annual basis.

The valuation bases adopted for assets and related liabilities, and the reconciliations between asset values for financial statements and for unit pricing should be explained to unit holders.

The legal documents that prescribe the operation of the fund may determine the bases of calculating asset values for unit pricing. Such prescribed methods should also be explained to unit holders.

Refer also to "Applying accounting standards".

Frequency of transacting and frequency of unit pricing

You should price as frequently as you make it possible to buy or sell units in the fund.

Many funds price at least weekly, and large retail funds price daily. It is noted that some superannuation funds may price only monthly or quarterly.

If you price weekly, you should batch the applications to buy or sell units, and process them on the day the unit price is struck.

If you do not batch the applications, you will need to implement procedures to prevent unit holders taking advantage of the last price to the detriment of other unit holders.

Frequency of unit pricing and frequency of asset valuation

In principle, unit prices should only be struck with the same frequency as asset values are determined.

However, as noted above, the timing of asset valuation depends on the nature of the assets and the valuation process adopted. In some cases reasonable estimates of asset values may need to be used, as discussed in this section.

Assets valued periodically using recognized methodologies

Where there are recognised methodologies, as for property and infrastructure, valuations should be obtained periodically from reputable, professional, third party valuers. Where more than one such asset is held in the portfolio, the periodic valuations should occur at different times to avoid concentrating the effect of any changes in valuation and so causing a price "spike".

Such periodic valuations also assist in early identification of significant market shifts, and so indicate when it may be prudent to obtain new valuations for other properties.

Between these periodic valuations, the value of the asset should be considered each time a price is struck. Where it is expected, for example based on experience, the nature or the asset or market movements, that the value of an asset is likely to increase at the next valuation, it may be appropriate to estimate, and include in the unit price calculation, a gradually increasing value. Otherwise, if the price increases suddenly at the end of the period, there will be a price "spike". Those who sell immediately before the spike will be disadvantaged. Those who buy immediately before the spike will be advantaged. Any such estimates should be prepared on a sound basis and the assumptions should be reasonable.

Spikes cannot be avoided. Once a value has been determined it should be included in the unit price. However, to promote equity between unit holders, steps should be taken to minimise the effects of price spikes.

Illiquid assets

Where an asset is valued infrequently, for example certain hedge fund assets might only be valued every three months, daily or weekly prices cannot be struck during the three months unless there is a reasonable basis for approximating the unit price for the fund holding the illiquid assets. The use of estimation may be acceptable where illiquid assets comprise a small part of a large portfolio. However estimation would not be appropriate where illiquid assets comprise a significant part of a portfolio.

The development of such estimates should be consistent with the entity's valuation policy, the entity's legal obligations and the rules that govern the operation of the fund. The bases and assumptions should be reasonable and documented.

"Going concern" basis of valuation

Assets should be valued on a "going-concern" basis, unless this is clearly unsuitable, for example, where a scheme is being wound up and the assets are to be sold quickly.

If an asset is not traded on a deep, liquid and well-maintained market, the intended period to hold the asset should be considered when determining the basis for valuation. A long-term view is inappropriate if it is expected that the asset will be sold in a short timeframe.

Thinly traded assets

Careful consideration is required when using the last available price for a thinly traded asset. There is no certainty that the last available sale price would be realised if the current holding were to be sold now. Special pricing models may be needed for such assets.

Responsibility for valuation of non-exchange traded assets

In all cases where values are not directly obtained from a market, that is, where values are determined by applying a model, or by periodic third party valuation, or by using an estimate between specific valuation dates, the fund manager should be satisfied that the bases of the valuation (both the model and the assumptions) are appropriate. The model and the assumptions should be periodically reviewed.

The fund manager may seek third party professional advice, but cannot delegate responsibility for determining the asset value.

The bases of the valuation need to be objectively reasonable, independently verifiable, internally consistent, and not subject to undue influence by the fund manager.

Valuation methodologies also need to be consistent with the documents governing the operation of the fund, and related disclosures.

Foreign currency

For assets denominated in a foreign currency, the appropriate exchange rate may be identified in the fund documentation. Otherwise the exchange rate may be either the Reuters 4pm London Exchange Rate or the last exchange rate at which a transaction in that currency took place, if more appropriate.

Inclusion of transaction costs in asset values

Asset valuations should not include allowances for the costs of buying or selling those assets. There is a separate allowance for transaction costs included in the unit price.

Refer to "Unit pricing issues common to many products".

Your comments

Q23 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q24 Do the proposals above raise other issues that also require consideration?

Q25 There is increasing use of "alternative" asset types and alternative strategies, where the value of the underlying assets may not be available with the same frequency as the fund manager wishes to strike a unit price. We propose that estimates should not be used to strike prices if these investments become more than a small part of the investment portfolio. What difficulties, if any, might arise from this proposal?

Q26 What issues might arise in the valuation of assets that are not traded on a regulated market?

Determining tax treatments

For some products, tax effects are included in the unit price. Determination of tax treatments for unit pricing is primarily an issue for superannuation funds, pooled superannuation trusts and the investment-linked products managed by life insurance companies.

Issues relating to other unit trusts and their distributions are not discussed in this guide.

Treatment of imputation credits

A company pays tax on its income before dividends are distributed. To avoid double taxation, a fund manager or life insurer investing in shares receives both a dividend, and related imputation credits. These imputation credits reflect tax already paid by the company and provide a reduction in tax liability for the fund manager or life insurer. There are issues relating to the time when the fund manager or life insurer can recognise these imputation credits for the calculation of the unit price.

A similar timing question may arise for foreign tax credits related to investments in international assets.

Treatment of deferred tax assets (or future income tax benefits - FITBs)

Funds may have actual or net unrealised tax losses that can be carried forward as assets (FITBs). These FITBs are available to offset future capital gains tax liabilities or future unrealised gains. They may also reverse through market movements. There are issues relating to the amount of FITBs that can be recognised, and the circumstances in which FITBs can be recognised.

The unit pricing survey showed there is a diversity of practice in recognising FITBS.

Treatment of capital gains

Some assets are subject to capital gains tax. Capital gains (or losses) arise where a taxpayer disposes of such assets at a profit (or loss). Net capital gains are included in a taxpayer's return as assessable income.

There are special tax rules for the treatment of capital gains in superannuation vehicles. Where an asset is sold within 12 months of acquisition, the gain is taxable at 15%. Where it is sold more than 12 months after acquisition, the gain is taxed at 10%. For some assets held for a long time, the prior basis, allowing for CPI indexation, may apply instead. There are issues relating to the treatment of unrealised capital gains and losses, based on assumptions about future asset turnover.

Reconciliation of tax amounts used in the accounts and for unit prices

For both current and deferred tax, periodic reconciliations followed by investigation of differences – for both financial statements and tax returns -

may assist in preventing or identifying unit pricing problems. There are issues relating to the timing of reconciliations and the treatment of any differences.

The unit pricing survey showed a range of practice. Most respondents reconciled current tax daily, monthly or quarterly, although some reconciled current tax only when preparing the tax return. Deferred tax was generally reconciled less frequently than current tax. Some entities did not reconcile the movement between current and deferred tax.

The unit pricing survey also showed that the great majority of respondents, when finding a difference between current tax in unit pricing and in the financial statements, credited or debited the difference to unit holders. A few respondents credited or debited the difference to a reserve for the future benefit of unit holders.

Administration of tax

Tax treatments may be inconsistent with statements in related legal documents. Tax policies may not address all relevant issues.

We also note that particular care may be required in determining tax treatments for a pooled superannuation trust that operates both an accumulation and a pension phase and does not segregate the assets.

On the alert

The following is an indication of the types of issues that may arise, based on what we have seen. It is not intended to be an exhaustive list.

Treatment of imputation credits

Imputation credits may not be counted at all, or may be counted later than appropriate. A change from direct investment in shares to investment in shares by way of a trust requires a change in the treatment of the associated imputation credits.

Similar issues, although to a smaller extent, arise for foreign tax credits.

Treatment of deferred tax assets

FITBs may not have been periodically reviewed to determine whether the amounts used for unit pricing are reasonable. Where a view is formed that amounts are overstated, FITBs may not have been reduced to an appropriate level. Periodic review and write down, if necessary, will assist in avoiding sudden large changes in asset values and so assist in avoiding unit price "spikes".

Treatment of capital gains

There have been instances where the tax liability used for unit pricing has been overestimated.

Reconciliation of tax amounts used in the accounts and for unit prices

Reconciliations may not be undertaken or differences investigated. Tax refunds may not be promptly obtained or included in the reconciliation calculations.

Administration of tax

Administration of tax for unit pricing requires substantial attention to detail. Errors have arisen where:

- the tax functions required for the unit pricing process have not been appropriately resourced
- the operations of the tax functions for the unit pricing process have not been appropriately reviewed
- appropriate tax policies have not been developed
- significant changes have occurred in investment structures
- there have been changes in tax personnel.

Proposed guidance for good practice

Periodically review your tax policy and ensure you are satisfied that this policy complies with relevant legislation, and is otherwise determined on a reasonable basis.

While allowance for tax may involve some level of estimation – as the timing or size of future cash flows is uncertain - you should adjust these estimates as soon as information on the actual tax position becomes available.

Treatment of imputation credits

Imputation credits need to be addressed in three cases.

1. When you invest directly in shares, we expect you to recognise both the dividend and the imputation credit in the unit price from the date the share is ex dividend. At the ex date, the dividend and the associated tax benefit are removed from market assessment of the asset value. If the imputation credit is not recognised with the dividend, the assets of the fund after tax will be understated. It is too late to wait for the annual tax return calculation to include these imputation credits.

2. When you invest in a unit trust, other than a pooled superannuation trust, that you do not control and the trust invests in shares, your ability to include imputation credits in the unit price will depend on the frequency of distributions by the trust and the availability of the related tax information.

We expect imputation credits to be included in the unit price as soon as information is available. It is too late to wait for the year-end final distribution to include imputation credits. Where the sub-trust does not periodically distribute or provide periodic information on imputation credits, a soundly-based procedure to progressively estimate imputation credits during the year would be an acceptable alternative.

3. When you invest in a unit trust that you control, we expect imputation credits to be reflected in the unit price in a way that mirrors the approach for non-controlled trusts. This could be on a progressive basis, or on the basis of periodic information. This will minimise the likelihood of a sizeable "spike" which could arise if the imputation credits were recognised once a year.

Foreign tax credits, on the other hand, usually have a smaller impact, are less predictable and are more difficult to progressively estimate. Except in funds where foreign tax credits have been significant historically, it would be acceptable to wait for the annual tax calculation to include foreign tax credits.

Treatment of deferred tax assets

FITBs should be included in unit prices to the extent that they have value for present or future unit holders, taking into account possible events, the likelihood and timing of those events, and the time value of money. The value of FITBs included in unit prices should be systematically reviewed. Your FITB policy should be periodically reviewed, seeking to achieve equity between investors, and to minimise "spikes" in unit prices.

You should apply consistently a soundly-based policy to recognise FITBs, reflecting the circumstances of the fund. We would not expect to see a policy that always, or never, recognises FITBs.

It is reasonable to consider capping the amount of FITBs included in unit prices. For this and other reasons, the amount of FITBs included in unit prices may not match the amount of FITBs reported in financial statements.

Treatment of capital gains

Assessment of deferred tax on unrealised gains and losses can be complicated:

- The tax rules are complex
- A fund may have many types of assets in one taxation pool and there may be interaction of tax effects between multiple investor options within one taxation pool.
- The assets are likely to have been held for various periods of time.

You should consistently apply a soundly-based policy. The treatment will depend on the length of time the asset is to be held before it is finally sold. Where an asset is held for less than a year, in many cases deferred tax will be calculated on the undiscounted capital gain rate of 15%. In some cases, however, there may be a sound basis for adopting a different approach. Where an asset is held for more than a year we expect deferred tax will be calculated on the discounted capital gain rate of 10%, unless the old CPI basis applies.

Reconciliation of tax amounts used in the accounts and for unit prices

You should prepare three types of reconciliation, where relevant:

1. compare and resolve differences between the allowance for current tax in the unit price with the corresponding provisions in the accounts and tax returns and with payments to the Australian Tax Office.

2. compare and resolve differences between the amounts of deferred tax in the unit price with the amounts of deferred tax in the accounts.

3. compare and resolve differences between the movement in current tax and the movement in deferred tax.

These reconciliations should consider the amounts used for unit pricing with the amounts, separately calculated, used in financial statements and tax returns.

Preparing reconciliations once a year, within three months of the due date for payment of tax, is the minimum acceptable frequency for preparation of reconciliations, and is appropriate only for funds with simple tax arrangements. Funds with more complex tax arrangements including current and deferred tax, generally require quarterly or at minimum six monthly reconciliations for both current and deferred tax. Current tax reconciliations could be performed more frequently.

Treatment of differences identified during reconciliation

For unit-linked investors where there are amounts held in mixed product pools, differences between tax amounts in the unit price and tax amounts in the financial statements should be applied equitably, taking account of the reasons for the difference and the nature of the products. For example, this may include transfers within the fund between product pools.

We would normally expect such differences to be applied for the benefit of unit holders, and that this practice would be applied consistently and would be disclosed.

Crediting differences to a reserve is acceptable where the reserve complies with our guidance on reserves. Refer to "Determining use of reserves".

Adjustments arising from consistent application of policy are not errors requiring compensation

You should develop and document a reasonable policy for tax treatments in unit pricing. You should apply that policy consistently, including circumstances where the policy requires the exercise of judgement. The assumptions and bases for the judgement should be appropriate, and should be documented.

A unit price prepared in accordance with such policy is not incorrect, for the purpose of deciding whether compensation is required, where the actual tax amounts are subsequently found not to match the estimates, based on sound judgement, previously used to calculate the unit price. In this case an adjustment can be made to the unit price.

Similarly, the policy for tax treatment should be reviewed from time to time and updated where appropriate. Where policy has changed on a reasonable basis that is documented, you may make reasonable changes in the calculation of unit price without either the unit price before the change, or the unit price after the change being incorrect for the purpose of determining whether compensation is required.

Where a change is made to unit price, as a result of a change in policy, the change should be made as soon as possible. Such change should not be implemented gradually over a period of time.

It is important to note that compensation does need to be considered where the policy is inappropriate or where the application of policy is deficient.

Administration of tax

Develop comprehensive tax policies. Review these policies periodically and update as changes arise.

Develop and implement procedures to apply your tax policy consistently. Periodically review your implementation of procedures. In particular, where there are procedures for using assumptions about tax in unit pricing, such assumptions should be periodically checked by tax specialists.

Your comments

Q27 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q28 Do the proposals above raise other issues that also require consideration?

Q29 Do you see any problems arising from counting imputation credits at ex-date, when investing directly in shares?

Q30 Do you see any problems arising from counting imputation credits when the dividend is received by a controlled trust or by an externally managed trust?

Q31 Do you see any problems arising from reconciling current and deferred tax amounts quarterly?

Q32 Do you see any problems arising from the recognition of FITBs in unit prices where the FITBs have a value. What factors would you consider in determining the level of a cap?

Determining use of reserves

A reserve is an amount that is not allocated to members. It is an excess of assets over unit holder entitlements and fund liabilities.

Reserves affect unit price by transferring amounts into or out of the pool of fund assets on which unit price is calculated.

Reserves should not be transferred to the product provider. Reserves are made up of unit holder funds and these amounts remain attributable to unit holders.

(This is different to accrual of management fees in a fee reserve. Such accrued fees are attributable to the product provider.)

Types of reserve

Reserves have been used for a number of reasons, most commonly as a general reserve or an investment fluctuation or "smoothing" reserve.

For funds using crediting rates, investment fluctuation reserves have been used to hold back investment returns in good years to supplement payments in years of poor return. This affects member equity, as members who have taken the investment risk in good years do not receive the benefits of having taken that risk if they leave the fund, while other members entering at a later time receive those benefits in their stead.

Reserves have been used in other ways, particularly by non-profit superannuation funds and mutually owned life insurers, which have no source of funds other than member contributions. It is not possible to call up additional contributions from the members of a superannuation fund. In the environment of non-profit superannuation funds, reserves have been used, for example, to:

- invest in the fund's operations, for example, by acquiring updated computer systems.

- act as a buffer to pay for operational losses.

Smoothing reserves and unitisation

Unitisation is a way to equitably attribute a share of the value of invested assets to people holding units. Unitisation also enables direct reporting of returns in relation to the performance of the fund at any time. Unitisation provides greater transparency about investment performance.

The use of smoothing reserves to move returns from the period in which they were earned to later periods is not consistent with the principle of unitisation.

It should also be noted that a fund operating a smoothing reserve may not constitute a unitised fund under SIS Regulation 5.14 which provides that a unitised fund is exempt from the member protection standards under certain conditions.

On the alert

We have seen the following types of issue arise in the use of reserves. This is not an exhaustive list.

There has been insufficient periodic review of the bases for transferring amounts from unit holder funds into reserves. Reserves have become larger than required, and the subsequent rectification and reallocation to unit holders has been complex.

The purpose of reserves has not been clearly defined so the use of unit holder contributions has not been clearly defined.

Procedures have not been implemented to ensure reserves are used only for the intended purpose. The use of unit holder contributions has not been monitored and supervised appropriately.

Proposed guidance for good practice

Ensure that the purpose of reserves is clearly described

If assets are placed in a reserve and not allocated to unit holders in the calculation of unit price, the purpose of the funds in the reserve should be clearly stated and disclosed.

Define the rules and procedures

Before establishing a reserve you should describe:

- the principles that determine the amounts to be held in the reserve
- who has authority to decide when amounts held in the reserve can be used
- the procedures to manage the amounts in the reserve.

Review the purpose and rules

Reserves should be used for an agreed purpose that has a reasonable basis.

On a regular basis you should consider whether:

- The amount held in a reserve is appropriate for the stated purpose
- Reserving policies and procedures continue to be relevant
- The original purpose is still relevant for the operation of the fund

Any excess over the appropriate amount should be allocated to unit holders.

Explain the purpose and operation of reserves

Unit holders should have access to information about:

- The purpose of a reserve
- The calculation of amounts transferred between unit holder assets and the reserve
- The policies that govern the operation of the reserve.

Paragraph 52(2)(g) of the Superannuation Industry (Supervision) Act 1993 requires that any reserves be prudentially managed consistent with the fund's investment strategy and its capacity to discharge its liabilities as and when they fall due. The above steps will contribute to such management.

Do not use smoothing reserves with unitisation

Regulators will consider “substance over form” when reviewing the operation of reserves. The use of smoothing reserves is not consistent with the use of unit pricing.

Commencement of unitisation

When a fund is considering a change to unitisation there may be reserves in place. The need for any ongoing use of reserves should be re-evaluated before the transition to unitisation.

Generally, smoothing or investment fluctuation reserves should be distributed to members before the transition to unitisation.

Your comments

Q33 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q34 Do the proposals above raise other issues that also require consideration?

Q35 On what bases might reserves be used with unit pricing?

Applying accounting standards

Australian reporting entities must use the Australian equivalents of International Financial Reporting Standards (IFRS) to prepare financial statements for reporting periods commencing on or after 1 January 2005.

AASB 139 "Financial Instruments: Recognition and Measurement" provides that:

- Fair value is the amount for which an asset can be exchanged between knowledgeable, willing parties in an arm's length transaction.
- For a financial instrument quoted in an active market, the fair value is the quoted price. The appropriate price in an active market is usually the current bid price.
- If the current bid price is not available, the price of the most recent transaction is evidence of the current fair value if there has not been a significant change in economic circumstances since the time of the transaction.
- Financial assets are measured at fair value without any deduction for transaction costs that may be incurred on sale or other disposal.

Other asset valuation standards also require the use of fair value.

AASB 139 does not change the requirements for those superannuation funds that comply with AAS 25 "Financial Reporting by Superannuation Plans".

AASB 132 "Financial Instruments: Disclosure and Presentation" provides that a financial instrument can be recorded as equity only if the instrument does not include a contractual obligation to deliver cash to another entity (amongst other conditions). As a unit pricing product provider has a contractual obligation to deliver cash to unit holders when units are redeemed, unit holder entitlements will be recorded as liabilities rather than equity in financial statements.

On the alert

Entities responsible for unit pricing have advised us of the following types of compliance issues. This is not an exhaustive list.

AASB 139

The change in accounting standards brings into sharp focus the question of whether the asset values used for unit pricing need to match the asset values used in the financial statements, particularly for equity funds.

Some entities currently use the last sale price for both financial reporting and for unit pricing. If the bid price is to be used for financial reporting, they will need to either:

- Use different asset values for financial reporting (bid price) and unit pricing (last sale price). That is, they will need to keep two sets of records, with reconciliations and disclosures to explain the difference, and meet the consequent increased record keeping costs, or

- Change investment data recording systems to enable use of bid price, to match the approach required by AASB 139 for financial reporting, again with consequent increased costs.

Entities responsible for unit pricing have noted that, in some cases, the constituent documents of unit priced funds specify detailed methods to calculate unit prices. For example, there may be reference to calculating net asset value in accordance with accounting standards, or there may be reference to the use of last sale price to determine the price of fund investments. For documents such as life policies with individual members, or where member meetings are required to change the constitutions of managed investment schemes, there may be considerable difficulty or cost involved in changing documents.

In some cases entities have indicated that change may not be possible. In such cases the clauses of the constituent documents will determine whether the asset values used for unit pricing match the asset values used in the financial statements.

Entities have also noted that benchmarking indices are calculated using last sale price. If bid price is use to calculate unit price, and so fund performance, there may be ongoing discrepancies between index performance and fund performance, depending on the actual differences between last sale price and bid price.

AASB 132

Some entities have noted that unit holders are accustomed to refer to the equity section of the financial statements (assets minus liabilities) to determine total unit holder entitlements. This is no longer the case where unit holder entitlements are recorded as liabilities under AASB 132, and may be a cause of some confusion to unit holders.

It is noted that, for many years, life companies have recorded unit holder entitlements as liabilities, as payments based on insurance contracts are inherently liabilities.

Some entities have also noted that, where unit holder entitlements are classified as liabilities instead of equity, the amount of equity shown in the financial statements might more frequently appear as a negative amount. This may be a cause of confusion to unit holders and to users of financial statements generally.

Proposed guidance for good practice

The Financial Reporting Council has determined that the standards of the International Accounting Standards Board will be adopted, as implemented by the Australian Accounting Standards Board, for reporting periods beginning on or after 1 January 2005.

Accordingly, reporting entities must ensure they take steps to enable compliance. These steps are likely to include:

- Review of agreements between product providers and unit holders, including constituent fund documents, review of disclosure documents, and managed investment scheme compliance plans to ensure the impact of the new accounting standards on the operation of the fund is understood.

- Planning for and implementation of change to documents, if necessary.

- Planning for and implementation of change in unit pricing practice, where necessary.

- Modification to computer systems and unit pricing and accounting record keeping procedures, where necessary.

- Determination of new disclosures required, if any, and establishment of systems and procedures to ensure those disclosures are made.

Refer to the guidance under the heading "Managing change" above.

In addition to the comments above, more broadly the asset valuation methods used for unit pricing calculations should be determined on a sound and justifiable basis. Accounting standards provide a benchmark.

Entities may decide to use different bases for valuing assets for unit price calculations and to comply with financial reporting obligations. The overriding principle is that entities apply a consistent approach to asset valuation to promote equity amongst unit holders and as required in the documents governing the operation of the fund

While accounting standards provide a recognised basis for valuing assets, there is the potential for differences to arise. For example, to assist in providing equity, deferred tax may be discounted for unit price calculations. This treatment is not permitted under accounting standards.

Entities need to document their policy for asset valuation including the application of accounting standards. This policy should be subject to regular review. Entities should develop, implement and maintain procedures to ensure the policy is applied.

For more information, refer to "Determining asset values".

Where there is potential for confusion about unit holder entitlements, for example where entitlements are re-classified as liabilities rather than equity, entities should clearly explain to unit holders the change in classification, and where to find information about unit holder entitlements.

Where financial statements show negative equity, entities responsible for unit pricing need to ensure that appropriate disclosures are made to unit holders to explain the significance of this equity position. Auditors need to consider the relevant facts and take these explanations into account when forming their opinion on the financial statements.

Entities responsible for unit pricing need to explain and disclose their practice, using reconciliations as appropriate and explaining the consequences of the approach used to unitholders. This may include, for example, discussion of fund performance.

Your comments

Q36 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q37 Do the proposals above raise other issues that also require consideration?

Q38 What difficulties, if any, might arise in reconciliation and in preparing financial statements if the asset values used for unit pricing do not match the asset values shown in financial statements.

Q39 What difficulties, if any, do you see in explaining unit holder entitlements and the equity position generally where unit holder entitlements are treated as liabilities.

Consumer issues

Providing information about unit pricing

Product providers are subject to a range of obligations to provide information. For example, there are specific obligations to provide product disclosure statements and periodic statements to unit holders. In addition, product providers may provide information to unit holders to meet broader obligations, or voluntarily.

Product providers give information directly to unit holders, or in some cases may distribute information through advisers or brokers. In other cases AFS licensees should provide information directly to ASIC, for example, to notify non-compliance with licensee obligations.

Information relevant for unit pricing may be provided, for example, in the following ways.

Documents setting out the rights and obligations of product providers and unit holders

These documents include:

- Scheme constitutions for managed investment products
- Insurance policies for investment life insurance products
- Governing rules of the fund, including the trust deed, for superannuation products.

These documents generally explain matters including the circumstances in which units can be acquired or disposed of, and the approach to determining unit price. For example, a scheme constitution must make provision for a unit price that is independently verifiable.

(Section 601GA of the Corporations Act 2001 and PS 134 Managed investments: Constitutions paragraph .19)

Documents setting out compliance obligations

Compliance plans of registered managed investment schemes discuss procedures for calculating and reviewing unit prices and valuing assets.

(Section 601HA of the Corporations Act 2001)

Financial statements

Companies, registered schemes and disclosing entities provide annual financial reports to members. These reports provide information relevant for unit pricing, such as information about bases of asset valuation, and information about unit holder entitlements.

(Section 314 of the Corporations Act 2001)

Product disclosure statements (PDS)

The PDS is directed to people who are deciding whether to acquire units in a product.

ASIC Policy Statement (PS) 168 "Disclosure: Product Disclosure Statements (and other disclosure obligations)" notes at PS 168.20 a statement of legislative objective:

> "the broad objective of point of sale obligations is to provide consumers with sufficient information to make informed decisions in relation to the acquisition of financial products, including the ability to compare a range of products".

(Sections 1013D, 1013E, 1013F of the Corporations Act 2001)

A supplementary product disclosure statement is used, for example, to:

- Update the information in the PDS
- Correct an omission from the PDS
- Correct a misleading or deceptive statement in the PDS.

(Section 1014A of the Corporations Act 2001)

As a part of explaining key provisions of the constitution, trust deed, policy and other governing documents, or otherwise, you need to consider for each product the most appropriate way to provide the following information. Taking into account your legal obligations, you may decide to provide such information in the PDS and/or in some other accessible document or form:

- how scheme assets and scheme liabilities are valued and the frequency of valuation – this would include, for example, any impact of complying with AASB 139 "Financial Instruments: Recognition and Measurement"
- whether income entitlements are included in asset values to calculate unit price
- how fee and taxation amounts are included in the unit price
- other fees relating to the acquisition and disposal of units
- how the unit price is calculated and the frequency of calculation
- the method to calculate the costs of acquiring or disposing of underlying investments, when people acquire or dispose of units, and the effect on the unit price

- the types of costs, such as brokerage, that are included in transaction costs
- where historic pricing is used, the controls in place to prevent unit holders taking advantage of a subsequent change in market value that is not reflected in the previously set unit price
- the circumstances in which unit pricing might be suspended
- the approach to compensation in the event that an error does arise
- the purpose of, and the procedures relating to any reserves.

Transaction confirmations

Where a person acquires or disposes of a unitised product, the product provider confirms the details of the transaction including the date and description of the transaction and the amount paid.

(Section 1017F of the Corporations Act 2001)

Ongoing disclosure to unit holders about changes and events

Product providers should provide to unit holders information about material changes and significant events to the extent that, if people were acquiring units, that information would need to be included in the PDS.

(Section 1017B of the Corporations Act 2001 – see also the modifications for superannuation products in Part 10 of Schedule 10A)

Some managed investment product providers must instead comply with the continuous disclosure provisions, providing information that is not generally available, either to the market (for listed entities), or to ASIC (for unlisted entities), where a reasonable person would expect such information to materially affect the price or value of units.

(Subsection 1017B(2) and Chapter 6CA of the Corporations Act 2001)

Information about superannuation products

Providers of superannuation products must, at the request of current unit holders, or people who have been unit holders in the last 12 months, provide information to enable understanding of entitlements, the features of the product, the investments, and to assist in making informed judgements about the investment performance of the product.

(Section 1017C of the Corporations Act 2001)

Periodic statements

Each year a periodic statement is given to unit holders of managed investment, superannuation and investment life insurance products. These statements provide information including:

- opening and closing balances for the period
- a summary of transactions during the period
- return on investment during the period, and
- details of change in circumstance affecting the investment.

(Section 1017D of the Corporations Act 2001)

Websites

Product providers may provide information on websites, including the PDS and current prices for unitised products.

If a problem has arisen, website material may include frequently asked questions, media releases and information sheets to explain what has happened and how the problem is being rectified.

Correspondence with unit holders

If a problem has arisen, a product provider may decide that the best way to communicate with unit holders is to write directly to each affected unit holder, explaining what has happened and how the problem is being rectified.

Call centres

Call centres may be a significant source of information for unit holders. If a problem has arisen, in addition to other means of communication, call centre staff may be provided with scripts to explain what has happened and how the problem is being rectified.

Breach notifications

Information must be provided to ASIC regarding significant breaches of AFS licensee obligations. Depending on the circumstances this may include notification of problems with unit pricing.

(Section 912D of the Corporations Act 2001 and "Breach Reporting by AFS Licensees – An ASIC Guide")

On the alert

We have seen the following types of disclosure issue arise. This is not an exhaustive list of issues.

Statements about unit pricing must be consistent in related documents

You need to ensure that statements about unit pricing are consistent in all the documents that relate to any unit priced product. We have seen cases where the statements in scheme constitutions have not been consistent with the statements in the related PDSs. Where the PDS is inconsistent with the scheme constitution the PDS must be amended.

Consistency between statements in documents and unit pricing practice

You need to ensure that statements in documents match practice. For example a change in calculation method or approach to asset valuation, or a change in treatment of fees must be matched by the statements in the related life policy or PDS.

Information about changes in service provision or when a problem has arisen

Examples might include:

- change to the rules governing the operation of a fund, such as amendments to the trust deed or constitution
- integration of funds
- change in investment strategy
- unit pricing error

We have seen problems arise where:

- early advice has not been given to prospective, current and past unit holders, advisers or employer sponsors of superannuation schemes, as appropriate. Information should be provided before a change takes place to assist unit holders and potential unit holders to make appropriate decisions. Information should be provided as soon as possible after an error has been discovered. Move promptly to ascertain the nature and scale of the problem so you can notify affected people as soon as possible. Delay is not acceptable. (Refer to paragraph 1017B(5) of the Corporations Act 2001).
- complete information has not been provided about a change as it affects unit holders, including the products affected, the cause of the change, the size of the difference in unit price, the impact on individual unit holders, and who is bearing the costs. It may be appropriate to provide a chronology of events.
- complete information has not been provided about the steps and timing to fix a problem, including explanation of any compensation to be paid to unit holders and how compensation will be paid.
- all related documents have not been updated to reflect a change and to match the timing of the change.
- information has not been provided in a coherent and accessible form. Information has been provided in a fragmentary or obscure manner.

Proposed guidance for good practice

Understand your obligations

Product providers need to ensure that they understand their obligations:

- Timing – information should be given in time for unit holders to make decisions.
- Purpose of providing the information – this affects the extent, quality, format and delivery of the information
- Particularly in large corporate groups, where work areas provide services to many entities, there should be systems that assign responsibility to individuals, to ensure the information provision obligations of each product provider are met. (Product providers retain responsibility to ensure their obligations are met.)
- Product providers should remain up to date with changes in the regulatory framework.

Establish communication channels

Establish communication between the unit pricing, tax, accounting, product development, marketing, risk management and legal areas of the organisation, to ensure that unit pricing practice for any product is consistent with descriptions in related documents.

Conduct independent reviews

Establish periodic independent reviews of documents and practice, to check ongoing consistency of statements in documents with practice.

Conduct consumer testing, particularly to check the clarity of information to be provided to unit holders.

Apply good disclosure principles

Product providers need to consider the Good Disclosure Principles, described in ASIC PS 168. These principles are:

- Disclosure should be timely
- Disclosure should be relevant and complete
- Disclosure should promote product understanding
- Disclosure should promote comparison
- Disclosure should highlight important information
- Disclosure should have regard to consumer needs.

Develop and implement policy to ensure consistency

Build reviews into compliance and audit procedures to ensure consistency of documents and practice for ongoing and new products and for any products affected by change.

Develop and implement policy – be prepared to deal with unit pricing problems

Where there have been problems, accurate and accessible information should be provided to advisers or brokers, if appropriate, and to unit holders as soon as possible. Failure to disclose appropriate information in a timely way may be a breach of financial services laws.

Your comments

Q40 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q41 Do the proposals above raise other issues that also require consideration?

Q42 We state that delay is not acceptable when advising clients of changes or problems in unit pricing. What would affect the timeframe to provide information to unit holders?

Managing complaints

The term "complaint" refers collectively to any enquiry, complaint or dispute, however defined, that may be dealt with under a given internal dispute resolution procedure or by a particular external dispute resolution scheme.

(ASIC Policy Statement PS 165 "Licensing: Internal and external dispute resolution")

AFS licensees must provide dispute resolution systems for retail clients. Responsible entities of managed investment schemes, trustees of superannuation funds (other than self managed superannuation funds) and trustees of approved deposit funds must comply with additional requirements for complaints management.

(Sections 912A and 601GA of the Corporations Act 2001 and PS 134 Managed investments: Constitutions paragraphs .49 to .51, and section 101 of the Superannuation Industry (Supervision) Act 1993)

A dispute resolution system is also required where a financial product is available to retail clients and the person providing the financial product does not hold an AFS licence.

(Section 1017G of the Corporations Act 2001)

The Financial Services Guide provided to a retail client by an AFS licensee or by the licensee's representative must provide information about the dispute resolution system that covers complaints by people to whom the financial service is provided, as well as information about how that system can be accessed.

(Sections 941A, 941B, 942B and 942C of the Corporations Act 2001 .)

Effective complaints handling should, amongst other outcomes, increase levels of consumer satisfaction, and endeavour to improve the quality of products and services.

(Australian Standard AS 4269 – 1995 "Complaints handling")

On the alert

Unit holders do not have access to the same information as product providers and usually do not have sufficient information to identify a unit pricing problem. An error may have existed for some time before unit holders notice any impact. A query about unexpectedly low returns may reflect a unit pricing error. Certain types of complaint may need analysis for unit pricing impact in addition to consideration of the specific issues raised by the unit holder. A cursory approach to complaints classification will not identify hidden trends. The more quickly a unit pricing error is identified, the more quickly damage can be limited.

Complaints may be communicated in many ways. For example, a unit holder may make a complaint directly in an email or a letter, or as part of correspondence primarily addressing another matter, or in telephone conversation with a call centre operator. All information about unit holder concerns should be recorded in a central location to enable effective analysis and reporting.

External dispute resolution systems including the Financial Industry Complaints Service Limited (FICS) and the Superannuation Complaints Tribunal (SCT) are not required to deal with all types of complaint.

(ASIC Policy Statement PS 165 "Licensing: Internal and external dispute resolution" paragraphs .50 and .86)

Concerns about unit pricing are generally outside the jurisdiction of FICS and the SCT. Such complaints are excluded under the rules of these bodies, as unit pricing relates to the management of a fund as a whole and not to individual decisions.

Proposed guidance for good practice

Where an external dispute resolution scheme is not available, there is increased emphasis on the need for effective internal dispute resolution procedures.

PS 165.17 provides that, to make your internal dispute resolution procedures as transparent and accessible as possible and to assist with staff training and awareness, you should document your procedures. This includes setting out in writing:

(a) the procedures and policies for:
- (i) receiving complaints
- (ii) investigating complaints
- (iii) responding to complaints within appropriate time limits
- (iv) referring unresolved complaints to an EDR scheme
- (v) recording information about complaints
- (vi) identifying and recording systemic issue

(b) the types of remedies available for resolving complaints

(c) internal structures and reporting requirements for complaint handling.

You should provide a copy of the procedures to all relevant staff. A simple and easy-to-use guide to the procedures should also be made available to consumers, either on request or when they want to make a complaint.

PS 165 at paragraph .96 provides guidance on the application of the Australian standard on complaints handling to internal dispute resolution procedures in the financial services industry.

Complaints management is an essential part of risk management.

- Resources should be available to manage complaints effectively and consistently
- Employees should be encouraged to report instances of customer dissatisfaction.
- All customer feedback needs to be taken seriously and should be reported to senior management
- Analysis of customer complaints can assist in identifying systemic problems and emerging trends.

Communication channels should be set up across organisational divisions – this may include, for example, consumer affairs, risk management, legal, marketing, product development and unit pricing and other operational areas - to ensure the causes of complaints are understood and addressed.

Early identification, followed by thorough investigation and rectification action can significantly limit the impact of problems in systems or procedures.

For further guidance, refer to ASIC Policy Statement 165 "Licensing: Internal and external dispute resolution" and Australian Standard AS 4269-1995 "Complaints handling".

Your comments

Q43 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q44 Do the proposals above raise other issues that also require consideration?

Q45 What constrains your ability to operate an effective internal complaints management system?

Managing errors and compensation

Errors

If there are pricing errors, unit holders do not receive the benefits to which they are entitled. For example:

Errors adversely affecting unit holders on entry and exit

- If an error in calculation causes the unit price to be too high then, when a unit holder makes contributions, the unit holder loses the benefits that would have accrued if a greater number of units had been acquired at the appropriate lower price.

- If an error in calculation causes the unit price to be too low then, when a unit holder withdraws from the fund, the total amount paid to the unit holder for units redeemed does not reflect the higher value of the unit holder's entitlement.

Errors adversely affecting ongoing unit holders

- If an error in calculation causes the unit price to be too low then, when a unit holder makes contributions, that unit holder gains the benefits that accrue from the greater number of units acquired, at the expense of all other unit holders.

- If an error in calculation causes the unit price to be too high then, when a unit holder withdraws from the fund, the total amount paid to that unit holder for units redeemed is too high, at the expense of all other unit holders.

Where unit holders have gained an advantage due to a unit pricing error, the product provider may choose to bear the cost, or may seek to recover the amount from those unit holders. It may not be feasible to recover amounts overpaid in some cases.

Compensation

In principle, compensation returns unit holders to the financial position that would have existed if the error had not occurred, including compensation for the time value of money and investment performance.

For ongoing unit holders, compensation may be paid by issuing more units or by adjusting the price of units. The product provider ensures payment for example where there is a net increase in the number of units issued. For unit holders who have left the fund, compensation is often paid by cheque.

Unit holders do not usually bear the costs of compensation.

In addition, people holding units in a registered managed investment scheme may take action against the responsible entity for any loss under section 601MA of the Corporations Act 2001 and unit holders in superannuation funds may take action for loss under section 55 of the Superannuation Industry (Supervision) Act 1993).

Impact on product provider

The costs of error rectification and compensation can be substantial. Costs may include management effort or distraction from other parts of the business, damage to the reputation of the business, costs to calculate amounts of compensation payable and the payment of those amounts, costs of system and procedure rectification, as well as amounts paid for any external review or advice.

On the alert

The following types of compensation issue may arise, based on what we have seen. This is not an exhaustive list.

When an error has been identified, at the time when all attention needs to be directed to limiting damage and addressing the loss to investors, we have seen entities instead be engaged in establishing the processes to deal with these issues.

Where appropriate risk management procedures are in place, errors are likely to be detected early and damage minimised.

Where errors are not detected for long periods, compensation costs can be substantial, as unit price determines both numbers of units issued and amounts received on redemption. Where there is a pricing error for a transaction, the effect of that error – whether number of units on issue or assets in the fund – flows through all subsequent transactions, in addition to the effect of repeating the initial error in subsequent transactions, until it is identified and stopped. Errors may affect many thousands of transactions. All these transactions need to be effectively recalculated and corrected.

Identifying a source of funds to pay these costs and to pay compensation is a particular issue where the product provider is a non-profit entity, without substantial capital reserves. In such a case, the entity may look to insurance or to a service provider that caused the error, or may be able to draw on a compensation reserve built up over time from member contributions to the fund.

Proposed guidance for good practice

Responsibility for care in pricing units

Product providers are subject to a range of obligations depending on the product, including obligations as responsible entities, superannuation trustees, life companies or trustees generally. Many unit-pricing financial product providers have obligations as AFS licensees.

As a part of complying with these obligations, providers must manage risks – which includes ensuring there are adequate resources to develop reliable unit pricing systems and procedures, and to monitor the operation of those systems and procedures.

Avoid and minimise unit pricing errors

Establish systems to avoid unit pricing errors, including reliable cross checks of all data before it is used in calculations.

Ensure independent review of calculation systems and encourage internal audit reviews of systems and procedures.

Establish systems to detect unit pricing errors as quickly as possible, including comparison with benchmarks followed by investigation where there is a difference, and frequent reconciliations.

For more information, refer to "Effective risk management culture".

Manage unit pricing errors effectively

Regardless of the quality of the systems and controls, errors may still occur.

Establish policy and procedures to manage unit pricing errors and to address compensation issues. Priority should be given to rectifying any disadvantage to unit holders and preventing recurrence of the error.

If an error is detected in a unit price calculation, the product provider should take steps to:

- determine the number of disadvantaged unit holders – who has entered and exited the fund during the period of the error.
- consider the need for compensation – who has gained and who has lost and by how much.
- pay individuals or the fund, if compensation is appropriate. This includes making reasonable efforts to contact former unit holders.
- communicate appropriately with unit holders. Tell them what went wrong and why. Tell them how the problem will be fixed and when.
- This includes communication to unit holders affected by the error, even if they are not entitled to compensation.
- This includes making reasonable efforts to contact former unit holders.
- recover amounts from any other entities responsible for the error.
- prevent recurrence of the error, for example by reviewing and amending policies or practice, rectifying computer systems, or changing service level agreements with service providers.

Who receives compensation

Consistent with the principle of equitable treatment of all unit holders, we are generally of the view that unit holders are entitled to receive compensation to the extent that they have been disadvantaged by a unit pricing error. Where compensation is payable, it is payable to everyone who was a unit holder at the time the error occurred.

However it is noted that there is a range of practice in industry. We seek industry comment on the following issues.

Product providers have considered whether it is consistent with the obligations noted above to set a materiality threshold, or to differentiate between unit holders, for example, based on the size of the loss, or costs to compensate, when determining whether to pay compensation and to whom.

IFSA Guidance Note No. 4.00 "Incorrect Pricing of Scheme Units – Correction and Compensation" (IFSA GN 4) provides that compensation is required for those days where the price is incorrect by 0.3% or more of the price of a unit and, in those cases, where the total amount of the error is greater than $20.00 in the hands of the investor. IFSA GN 4 also notes that there may be circumstances where an error of less than 0.3% is material in absolute terms and it is appropriate to pay compensation.

Product providers need to determine whether they comply with their obligations by applying a materiality threshold for the size of the error for which compensation will be paid.

We expect that a compensation process will be put in place for all unit holders if the impact of one or more transactions, or if the impact on annualised returns to the unit holder is 0.3% or more, regardless of whether the error related to the price or number of units, or whether the error occurred in one day or accrued over a period of time. We expect that, where the effect is less, product providers will consider their obligations and the circumstances, including the duration and impact of the error and the number of unit holders affected.

When determining compliance with obligations it is acknowledged that there are a number of factors to be considered and balanced. As discussed above, soundly-based estimates may be used for some elements of unit price calculation. When deciding the extent to which compensation is payable, it may be relevant to consider the degree of precision that can be used in calculating unit prices. Any decisions based on such assessment would need to be well-founded and documented.

In some circumstances particular care will need to be exercised in determining compliance with obligations:

- Setting a dollar limit of loss to unit holders, below which compensation would not be paid, would discriminate between unit holders with larger and smaller investments.

- Considerable costs (including bank, correspondence preparation and postage charges) may be incurred in compensating unit holders who have left a fund before an error is identified but who held affected units at the time the error arose. This is a particular issue for non-profit superannuation funds, which need to identify a source of funds to make compensation payments and cover the expenses incurred in rectifying the error.

As noted above, you have primary responsibility to prevent unit pricing errors and to treat unit holders equitably. You also have a duty to act in the best interests of unit holders as a whole. It is acknowledged that, in some cases, the costs to unit holders of receiving compensation might outweigh the benefits to unit holders of receiving that compensation. This may be the case, for example where amounts of compensation are relatively small and where the unit holders bear the cost of compensation.

It is noted that in some cases fund managers may receive compensation benefits. Unit holders entitled to compensation will not always be retail investors. In the case of a fund of funds, the unit holder might be a fund manager in a sequence of fund managers. Compensation might be payable by one fund manager to another, who would then independently determine the need to compensate its own unit holders.

Your comments

Q46 If you consider that there may be difficulties in meeting the proposed good practice guidance as outlined above, can you suggest alternative ways to achieve similar outcomes?

Q47 Do the proposals above raise other issues that also require consideration?

Q48 We are proposing a test that has differences to the test in IFSA Guidance Note No. 4.00 to determine when compensation should be paid. What difficulties, if any, would you see in meeting this proposed guidance?

Reminder of obligations

Obligations relevant for unit pricing

The entities most likely to provide unit priced products in Australia are life companies offering investment life products and superannuation, allocated annuity and pension products, superannuation trustees offering superannuation funds, and fund managers offering wholesale or retail managed investment schemes and pooled superannuation trusts.

All such entities are subject to a range of duties when providing unit priced products. Some of these obligations are briefly outlined below. This is a general guide, and should not be regarded as legal advice. You are encouraged to seek your own professional advice in relation to the matters discussed in this guide.

Entities regulated under the Superannuation Industry (Supervision) Act 1993

Section 52 of the Superannuation Industry (Supervision) Act 1993 (SIS) deems that a number of covenants by Trustees are included in the governing rules of each regulated superannuation fund, approved deposit fund and pooled superannuation trust. The following covenants by Trustees are relevant for unit pricing:

- to act honestly in all matters concerning the entity *(paragraph 52(2)(a))*
- to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide *(paragraph 52(2)(b))*
- to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries *(paragraph 52(2)(c))*
- not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers *(paragraph 52(2)(e))*
- if there are any reserves of the entity—to formulate and to give effect to a strategy for their prudential management, consistent with the entity's investment strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due *(paragraph 52(2)(g))*
- to allow a beneficiary access to prescribed information, namely the information and documents that are available to a concerned person under section 1017C of the Corporations Act 2001 *((paragraph 52(2)(h))*

The SIS Act provides for a two-year transitional period commencing on 1 July 2004, during which all existing trustees must obtain a Registrable

Superannuation Entity (RSE) licence. All RSEs in existence at 1 July 2004 must also be registered during the transition period that ends on 30 June 2006. From 1 July 2004, all new trustees are required to be licensed and RSEs registered prior to commencing operations.

Operating standards made in relation to licensing requirements and relevant for unit pricing deal with adequacy of resources, outsourcing and risk management. *(Superannuation Guidance (SGN) Note 140.1 Adequacy of Resources, SGN 130.1 Outsourcing and SGN 120.1 Risk Management)*

Entities regulated under the Corporations Act 2001

Australian Financial Services licensees

Unit pricing entities holding AFS licences include life companies, some superannuation trustees, and fund managers including responsible entities of registered managed investment schemes. Obligations for provision of services under an AFS licence include:

- Doing all things necessary to ensure the services are provided efficiently, honestly and fairly *(s912A(1)(a))*
- Having adequate financial, technological and human resources, unless the licensee is a body regulated by APRA *(s912A(1)(d))*
- Maintaining the competence to provide those services *(s912A(1)(e))*
- Ensuring that representatives are adequately trained and competent to provide those services *(s912A(1)(f))*
- Having dispute resolution systems where services are provided to retail clients *(s912A(1)(g))*
- Having adequate risk management systems, unless the licensee is a body regulated by APRA *(s912A(1)(h))*.

Responsible entities of registered managed investment schemes

Fund managers offering managed investment schemes registered under Chapter 5C have additional obligations as responsible entities. These obligations include:

- Exercising the degree of care and diligence that a reasonable person would exercise in that position *(s601FC(1)(b))*
- Acting in the best interests of the members and if there is a conflict between the members' interests and the interests of the responsible entity, giving priority to the members' interests *(s601FC(1)(c))*
- Treating members who hold interests in the same class equally and members who hold interests of different classes fairly *(s601FC(1)(d))*
- Ensuring that scheme property is valued at regular intervals appropriate to the nature of the property *(s601FC(1)(j))*
- Ensuring that all payments out of the scheme property are made in accordance with the scheme's constitution and with this Act *(s601FC(1)(k))*.
- Ensuring that the constitution of a registered scheme makes adequate provision for matters including the consideration to be paid to acquire interests in a scheme, withdrawal from a scheme, and dealing with

complaints *(s601GA and Policy Statement 134 Managed Investments: Constitutions)*

Officers of responsible entities have related obligations, including taking steps to ensure compliance with the scheme's constitution *(s601FD).*

Directors and other officers

Directors and other officers of a corporation have obligations including the requirement to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise in those circumstances *(s180).*

Entities regulated under the Life Insurance Act 1995

As well as being subject to the requirements of the Corporations Act 2001, Life insurance companies and friendly societies are entities also regulated under the Life Insurance Act 1995. This Act imposes a number of obligations that are generally relevant, although not specific, to unit priced products.

These include an obligation for a director of a life company or friendly society to take reasonable care, and use due diligence, to see that, in the investment, administration and management of the assets of a statutory fund, the life company gives priority to the interests of the owners and prospective owners of policies referable to the fund *(s48(2))*.

In addition, section 116 of the Act provides that the appointed actuary must include advice on unit value methods as part of the advice in relation to issuing new types of policies that include units.