

FINANCIAL SERVICES BOARD

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CISCA CIRCULAR NO. 17 TO MANAGERS AND TRUSTEES OF COLLECTIVE INVESTMENT SCHEMES IN SECURITIES

This Office is aware that there are certain issues relating to the investment environment and related matters that are of concern to the industry which may affect the ability of managers to adhere to their investment objectives. The expectation is that the revision of the previous Notice 1503 to Board Notice 80 of 2012 ("Notice 80"), issued under the Collective Investment Schemes Control Act, 2002 ("CISCA"), has resolved some of these issues.

However, there are certain matters not directly related to Notice 80 which ought to be addressed. The most important of these matters are the following:

1. Settlement of Offers to Repurchase Participatory Interests

Traditionally the payment for offers to repurchase participatory interests could only be settled through payment in cash. However, the matter was investigated taking due cognisance of certain definitions in CISCA and the provisions of the Deed (as defined in CISCA). In this regard special attention was given to the definition of "sell". It will be noted that the definition of "sell" or "repurchase" includes "exchange". Furthermore, clause 6.2 of the Deed allows a manager to exchange any of the assets of a portfolio. This differs from clause 34.6 of the Deed which aims to ensure that an investor does not have an entitlement to assets and may not demand the same.

After reconsideration of all relevant issues, this Office has come to the conclusion that offers to repurchase participatory interests can also be settled *in specie*, which is to say that assets in a portfolio may be exchanged for participatory interests offered for repurchase by an investor, provided the investor elects in writing to accept assets *in specie* rather than cash.

This determination accords with the provisions of the definition of "administration" in section 1 of CISCA which allows for members of the public to be invited or permitted to invest money or other assets in a portfolio.

If a manager decides to compensate an offer to repurchase through the delivery of assets, the following will apply:

Board Members: AM Sithole (Chairperson) H Wilton (Deputy Chairperson) Z Bassa JV Mogadime
Prof PJ Sutherland D Turpin H M H Ratshefola D Msomi M Mnyande (Alternate)
I Momoniat O Makhubela (Alternate) **Executive Officer:** DP Tshidi

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- 1.1 The trustee, on receipt of such evidence of title as it may require, must –
- (a) verify the manager's calculation of the price of the assets to be delivered and the date therefor;
 - (b) ensure that the relevant participatory interests are cancelled; and
 - (c) ensure that the proportionate share of the assets in the portfolio is transferred to the investor.
- 1.2 In this instance "proportionate share" means –
- (a) such part of the assets in the portfolio as is proportionate to or as nearly as is practicably proportionate to the investor's share in the assets; or
 - (b) such selection from the assets of the portfolio as the trustee may, after consultation with the manager, decide is reasonable, having regard to the need for fairness in respect of both the investor concerned and the continuing investors.

2. Accrued Income or Income Accruals

The concept of "accrued income" is used in different contexts in CISCA and its subordinate legislation and in this regard the following should be noted: The reference to "accrued income" should be interpreted as income due, either to a portfolio or to investors, but not yet received. This is in line with common usage of the term.

- 2.1 Firstly, CISCA provides that "administration" includes *"the receipt, payment or investment of money or other assets, including income accruals, in respect of a collective investment scheme"*. In this instance the reference to "income accruals" should be interpreted as referring to income due to a portfolio for the benefit of investors but which has not yet been distributed to investors. This accrued income may be invested as permitted in accordance with the definition of administration but the manager should ensure that the accrued income, to be invested, is available for distribution on the first subsequent ex-dividend date after receipt thereof.
- 2.2 Secondly, for the purposes of treatment of accrued income as contemplated in the definition of "assets" in section 1 of CISCA, it should be noted that income accruals must be included when calculating the net asset value of a portfolio. This is supported by the words "... or are due to the investors in that portfolio" at the end of said definition. This also prevents the miscalculation of the net asset value of a participatory interest, especially after the declaration of a dividend on a share or a return on a debt instrument included in a portfolio.
- 2.3 Thirdly, clause 50 of the Deed determines that in the calculation of the service charge, "accrued income" should be excluded from the market value of a portfolio. The reference to "accrued income" in this context should be construed as income on underlying assets included in a portfolio and due to a portfolio but not yet received. However, were it not for clause 50 of the Deed, the interpretation of "accrued income" as used in CISCA, and in particular as described in 2.1 and 2.2 above, would lend itself to permitting the inclusion of accrued income as part of the assets of a portfolio which forms the basis of calculation of a manager's service charge.

- 2.4 Thus, should a manager wish to include accrued income as part of the assets of a portfolio which forms the basis of calculation of a manager's service charge, clause 50 of the Deed must be amended accordingly by means of a supplemental deed and investors must be informed in terms of sub-clause 50.2 of the Deed.

3. Repurchase Agreements

In the case where a manager enters into a repurchase agreement, the manager must ensure that the instrument which is the subject of the repurchase agreement and is to be included in a portfolio is of equal value as the asset with which it is to be exchanged and complies with all relevant provisions of CISCA, its regulations and Deeds. The portfolio may not suffer any losses as a result of the exchange of assets, both with the initial exchange as well as the return of assets. The repurchase agreement does not constitute a security and may not be reflected in the portfolio as an asset. It is anticipated that it may be necessary to publish a separate notice on repurchase agreements.

4. Inclusion of Non-qualifying Instruments

Section 2(1) of CISCA stipulates that *"a manager must administer a collective investment scheme honestly and fairly, with skill, care and diligence and in the interest of investors"*. In view of this provision it must be indicated that it often comes to this Office's attention that managers include in a portfolio instruments which do not qualify for inclusion. It is acknowledged that if a trustee detects such a wrongful inclusion and instructs the manager to dispose of the instrument, the disposal may be at a profit or a loss. If a profit is realised, the profit should go to the benefit of the portfolio. However, if a loss is realised, the manager must carry the loss as the inclusion of the non-qualifying instrument was not in the best interests of investors.

5. Scrip Lending

Section 85 of CISCA empowers a manager to lend or offer to lend assets included in a portfolio, in the manner, within the limits or on the conditions determined in the Deed. One of these conditions as determined in the Deed, viz. clause 6.6.7, prescribes that *"all fee income earned from securities lending, less necessary expenses, must be administered for the benefit of investors"*. This provision should be interpreted to mean that after the deduction of expenses directly related to a scrip lending transaction, the balance should be distributed to investors on a *pro rata* basis in proportion to their participatory interests in the portfolio as contemplated in paragraph (b) of the definition of "collective investment scheme" in section 1 of CISCA.

6. Suspension or Delisting of an Instrument

- 6.1 If an instrument is suspended from an exchange, the manager must use the last available price during the period of such suspension.
- 6.2 If an instrument is delisted from an exchange, the manager must either include the instrument as part of the permitted 10% of unlisted securities or dispose of the instrument within 12 months of delisting. However, if an instrument is delisted as a result of the liquidation of the entity that issued the instrument, the

value of the instrument must be written down to zero. The instrument must be re-valued as and when each liquidation account is issued, based on the amount of the distribution the portfolio will receive. Thereafter, the manager must endeavour to dispose of the instrument.

7. Separation of Funds of Investors and other Persons

7.1 Section 105 of CISCA refers to an operational trust account for the scheme or portfolio ("the section 105 account").

Payments by investors on application for investment into a portfolio must not be made directly into the section 105 account. Prior to transfer of payments into the section 105 account, all investors must be properly identified and verified in terms of all relevant anti-money laundering and anti-terrorism financing legislation. A manager must decline an investor's investment if the investor has not made proper disclosures or the investor is not considered appropriate as an investor to the portfolio. In this instance the investor's investment may not be transferred to the section 105 account.

Any account operated by the manager for the receipt of monies from investors prior to transferring it to the section 105 account, must be operated on the basis of the separation of assets as provided in terms of section 104 of CISCA and with proper identification of each investor as determined under section 2(2) of CISCA. Such an account must also be subject to the Protection of Financial Institutions (Protection of Funds) Act (No. 28 of 2001).

The operational trust account should be opened by the manager using its registration number, .e.g. Manager X, registration number Y, i.t.o. section 105 of CISCA.

As the trustee might not have sight of the underlying investors of the portfolio, the manager must provide the trustee, on a monthly basis, with a reconciliation report of this account (per portfolio where applicable) providing details on the following as a minimum:

- (i) All items unallocated for more than a week;
- (ii) Bank statements;
- (iii) Inflows split into the amounts for funds to be transferred to the portfolio for participatory interests' creation and the amounts due to the manager and charges;
- (iv) Daily redemptions
- (vii) Manager's fees; and
- (viii) Distributions to investors.

The section 105 account may not form part of a portfolio, that is, it may not be "the portfolio account" as it may neither form part of a portfolio's assets in liquid form, nor may it be included in the portfolio exposure limits.

7.2 When monies are deposited into the portfolio against the issue of units, or where a banking account is used to buy and sell assets (settlements and liquidations of securities), netting of cash transactions and payments by the portfolio (e.g. redemptions) etc., such an account must form part of the portfolio as assets in

liquid form and be subject to the exposure limits. This account is generally referred to as the portfolio account.

- 7.3 The trustee will have control over all the portfolio accounts and these accounts should be opened and styled as follows: The portfolio name, i.e. "Global Equity Fund Y c/o the Trustee" or "XYZ Bank Limited in trust for/as trustees for ABM Fund".

8. Money Market Instruments Purchased in the Secondary Market

Transactions under money market portfolios relating to unlisted money market instruments, purchased in the secondary market, must be treated as follows:

- 8.1 The nominal value of an instrument will be the actual face value of the instrument;
- 8.2 Any premium or discount should be reflected in the income account;
- 8.3 The premium or discount must be amortised on a daily basis. In the case of a fixed rate instrument, amortisation should be done over the term remaining to the maturity of the instrument; and in the case of a variable rate instrument, amortisation should be done over the term to the next reset date if the instrument complies for inclusion as set out in Chapter II of Notice 80; and
- 8.4 Any profit or loss made when an instrument is sold must be taken into the income account on the date of such sale.

9. Asset Management Fees as Fixed Costs

It has been noted that a number of managers treat the fees that they pay their asset managers as a variable cost in their capital adequacy calculations. This is incorrect. Asset management fees are part of fixed expenditure under the capital adequacy report and must be included under "Charges or fees" or "Other expenses" as provided for in the capital adequacy report.

10. Notice 80 of 2012: Incorrect Reference

The content of Annexure A to Notice 80 incorrectly refers to Chapter VII. The reference should be to Chapter V of the Notice, being the chapter providing for the inclusion of financial instruments in a portfolio. The report should be submitted to the Registrar with the corrected reference.

11. Accounting Standards

In terms of section 74(1)(a) of CISCA, a manager must maintain accounting records and prepare annual financial statements need to be prepared in conformity with generally accepted accounting practice.

When CISCA was written, the intention was that generally accepted accounting practice would always refer to the permitted accounting standards at the applicable time.


With effect from 1 December 2012, International Financial Reporting Standards (IFRS) will be the only permitted standards for the maintaining of accounting records and the preparation of financial statements. Accordingly, section 74(1)(a) of CISCA must be read as a requirement to apply IFRS with effect from 1 December 2012.

12. Swap Transactions for Money Market Funds

Notice 80 now permits the use of an interest rate swap in a money market portfolio against an underlying money market instrument. To avail of this facility as provided for in the Notice, the investment policy contained in the supplemental deed of a particular money market portfolio must be amended to reflect that interest rate swaps may be used. Furthermore, all investors invested in the portfolio must be given three months' notice of the amendment to the investment policy.

13. Acknowledgement of Receipt

Kindly hand a copy of this circular to your auditor. The attached acknowledgement of receipt, duly signed by the chief executive officer of the manager and by the auditor, must be returned to the Office as soon as possible.



D P TSHIDI
REGISTRAR OF COLLECTIVE INVESTMENT SCHEMES

REGISTRAR OF COLLECTIVE INVESTMENT SCHEMES

ACKNOWLEDGEMENT OF RECEIPT

I acknowledge receipt of a copy of CISCA Circular No. 17

Signature

Name of Manager

Date

Signature

Name of Auditor

Date

Please return on/before 31 August 2012 to:

Facsimile No. 012 346 6533

kabowa.modjadji@fsb.co.za