FINANCIAL ADVISORY AND INTERMEDIARY SERVICES ACT, 2002
(“FAIS ACT”)

FAIS CIRCULAR 1/2013

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Information Circular: Disclosure of Fees and other potential Conflict of Interests on Third Party Collective Investment Scheme Portfolios

1. Introduction

Third Party Collective Investment Scheme Portfolios (“Third Party Portfolios”) emerged prior to the enactment of the Collective Investment Schemes Control Act in 2002. These portfolios were intended to assist emerging third parties who did not have the capacity to become a Collective Investment Scheme (“CIS”) Manager to co-brand the CIS Manager’s portfolios whilst acquiring the required level of skills and experience to be authorised as CIS Managers in their own right. In terms of this practice, some investment managers were able to introduce CIS portfolios using the licence of an existing CIS Manager until they had enough assets under management to manage a viable scheme. The practice also enabled some larger brokers/intermediaries to launch their own CIS portfolios, commonly known in the industry as “Broker Funds”.

Third Party Portfolios, especially Broker Funds, have attracted wide criticism for being more expensive for investors. Financial Services Providers (“FSPs”) who promote these portfolios have also been criticised for not disclosing all applicable fees and other potential Conflicts of Interests that may arise.

2. Purpose of this Circular

The Registrar is concerned that FSPs who promote Third Party Portfolios are not appropriately complying with the requirements in respect of disclosure and Conflicts of Interest as contained in the General Code of Conduct for Authorised Financial Services Providers and Representatives published under Board Notice 80 in Government Gazette 25299 of 8 August 2003 (“General Code of Conduct”).

This circular is intended to provide FSPs who promote Third Party Portfolios with guidance on compliance with the requirements in respect of disclosure and Conflicts of Interest and is in line with the disclosure requirements applicable to the CIS industry.
3. Fee Structure

The following fees may apply when a client invests in a Third Party Portfolio:

3.1 Initial Fees - These fees are related to the product and deducted up-front from the investment amount, effectively reducing the investment amount. They are payable to the CIS Manager in respect of the opening of the client investment account and reflect the costs of developing and marketing the portfolio as well as the administrative costs associated with the investments in the portfolio. They may also include an initial advisory fee payable to the FSP who recommended the product to the investor.

3.2 Advisory Fees – These fees reflect the arrangements that the FSP has made with the CIS Manager to have the amount deducted from the client’s investment monies to pay the FSP an initial advisory fee for developing a financial plan and providing initial advice and/or an ongoing fee for continuing advice to the client.

3.3 Management Fees - these are on-going annual fees payable to the CIS Manager for costs incurred in packaging the Third Party Portfolio in the most appropriate form and for the on-going administration of such portfolio. The CIS Manager inevitably pays a portion of these fees to the FSP for managing the investments in the portfolio. However, management fees which are levied and disclosed at the CIS Manager level, do not necessarily show amounts that the client pays to the FSP for providing advice.

3.4 Performance Fees – this fee is a type of management fee which may be levied by the FSP (i.e. investment manager) for outperforming a set benchmark while managing investments in the portfolio.

3.5 LISP Administration Fees – the LISP may levy these fees in respect of the administration platform on which the portfolio is included. They are payable either by the CIS Manager out of its management fees, or by the client through the sale of units.

3.5 Rebates - the LISP making the portfolio available on its platform may rebate to the client part of the initial and/or on-going fees received from the CIS Manager. Alternatively, the CIS Manager may issue additional units to the client in lieu of the rebate.

There are two different ways of levying the above-mentioned fees:

- The “original fee structure”, whereby the LISP administration fees and FSP’s advisory fees are calculated annually and deducted monthly by selling off CIS units. These fees are very transparent, as the client can see them clearly reflected on the quarterly statements as redemption of units or as a disinvestment out of the cash account. However, in cases where the CIS Manager shares fees with the FSP for providing advice, the LISP will not reflect these fees (as it is not party to the arrangement) and separate disclosure is required.
The “all-in-fee structure”, whereby the CIS Manager bundles the LISP administration fees and FSP’s advisory fees into the management fees. In this case, the CIS Manager levies management fees, but shares them with the FSP for investment management services and also pays a portion to the LISP on behalf of the client for administration fees and FSP’s advisory fees. The LISP then retains its administration fees and pays the FSP’s advisory fees.

4. **Non-disclosure of Fees and Costs**

The following are instances where FSPs have in the past failed to disclose all fees applicable to Third Party Portfolios:

4.1 FSPs acting in two capacities as investment manager and adviser, only disclose upfront fees payable to them for providing advice, but fail to declare management fees which they receive from the CIS Manager.

4.2 The fees that are disclosed are generally only at the level of the underlying portfolio in a Fund of Funds portfolio and not the total investment or product costs. A Third Party Fund of Funds may have a complex fee structure, which may include: the cost of the underlying portfolios, on-going management fees which may include performance fees, LISP administration fees, and advisory fees, if applicable. All these fees have in the past not been sufficiently disclosed to investors.

4.3 Some FSPs rely on the Total Expense Ratio (“TER”) to disclose portfolio fees. Note however that the disclosure of the portfolio’s TER is subject to availability of information from the CIS Manager. Secondly, the TER only discloses costs incurred in the prudent operation of the portfolio, which are deducted from the portfolio’s assets. The TER excludes costs that are incurred directly by the client such as: initial fees, advisory fees, or ongoing fees for financial advice, if applicable. These fees are levied in addition to any other fees levied by the portfolio and should be disclosed separately to clients.

5. **Non-disclosure of Remuneration Arrangements and Rebates**

5.1 It has been noticed that certain CIS Managers remunerate FSPs by virtue of an arrangement between the CIS Manager and the FSP as a result of business submitted by such FSP. These arrangements may commonly be referred to as rebates or discounts in respect of business placed with a CIS Manager when in fact they are a commission, payment or remuneration of some sort. Some FSPs that are able to negotiate remuneration arrangements for the submission of business with CIS Managers and have not passed on such remuneration to the client, failed to disclose the receipt of such remuneration to their clients and the reasons for such remuneration. This is a contravention of section 3A(1)(a)(ii) of the General Code of Conduct which stipulates that FSPs may only receive fees if such fees are specifically agreed to by a client in writing and may be stopped at the discretion of the client at any given point in time.
5.2 In some instances, the CIS Manager passes client rebates to the LISP and the LISP utilises the rebate to offset LISP administration and/or adviser fees. This would be reflected in clients’ statements. However, there are instances where the CIS Manager pays the adviser a trail fee directly, the payment of which is not facilitated by the LISP and the LISP would not be in a position to include these details in clients' statements. Some FSPs claim to rely on LISPs or CIS Managers to disclose these arrangements to clients and fail to make their own disclosures to their clients. CIS Managers are product suppliers and cannot be compelled in terms of the General Code of Conduct to disclose remuneration arrangements.

6. **Non-disclosure of Conflicts of Interests**

The following are instances where FSPs in the past have failed to disclose Conflict of Interests when rendering financial services on Third Party Portfolios:

6.1 It is common for Conflicts of Interests to exist due to the manner in which Third Party Portfolios are distributed, particularly where the FSP promotes one portfolio only and all clients are advised to invest in it.

6.2 There is also a potential Conflict of Interests where the FSP acts as both advisor and investment manager to the same portfolio. In this case, clients are often not informed of the FSP’s dual role and the related remuneration received for performing each function for the portfolio.

6.3 A potential Conflict of Interests may also exist where the FSP retains rebates that are successfully negotiated with the CIS Manager. Board Notice 58 of 2010 states that:

> “a provider or its representative may only receive a financial interest from a third party for the rendering of a financial service, if those fees are specifically agreed to by a client in writing”.

In the past, clients have not been properly informed about the rebate arrangement between the FSP and the CIS Manager(s) and as such have consented to the rebate arrangements without understanding the full implication of doing so.

6.4 Another potential Conflict of Interests may exist where the FSP does not act in the clients’ best interests or does not provide clients with all the information that they need to help them decide whether the portfolio under consideration is suitable for them. FSPs tend to continue to promote Third Party Portfolios and to advise their clients to invest in these even if such portfolios are not providing good performance on a consistent basis compared to similar portfolios. Furthermore, since clients’ risk/return profiles are not the same, FSPs have not in the past disclosed to their clients why other portfolios were not considered suitable for the client’s investment time-frame, return expectation, and risk tolerance.
7. Disclosure requirements in the CIS industry

The Registrar of Collective Investment Schemes determined Limits and Conditions for Third Party Named Portfolios of Collective Investment Schemes in Notice 778 of 4 November 2011. The Notice regulates Third Party Named Portfolios by providing for two categories of arrangements which will be allowed:

7.1 The first category caters for FSPs that are starting up and need to leverage on the licence of an existing CIS Manager before registering a scheme of their own. These FSPs will operate what is called “Incubator Portfolios”. The Incubator Portfolios will be branded in the name of the FSP, but the FSP will have to apply for registration as a CIS Manager within three years of launching the portfolio. The CIS Manager that hosts the Incubator Portfolio and the FSP that is hosted will have to disclose to investors in all communications, its identity, contact information, and its role and responsibility as the CIS Manager of the portfolio.

7.2 The second category caters for FSPs that have no intention of becoming a CIS Manager in their own right. They will operate what is known as “Co-Named Portfolios” which will have to be branded in the name of the FSP and the CIS Manager. The CIS Manager that hosts the Co-Named Portfolios will enter into an agreement with the FSP and will be expected to commit itself to running the portfolio as if it were its own, even though the FSP will be responsible for promoting the portfolio. The CIS Manager remains responsible and accountable for the portfolio and must disclose its identity and its role in respect of the portfolio to investors. The portfolio must also be marketed under the portfolio’s registered name. In the agreement, the parties are required to address all potential Conflict of Interests.

8. Action to be taken by FSPs

FSPs who promote Third Party Portfolios should take the necessary steps to ensure compliance with the requirements in respect of disclosure and Conflict of Interests. These may include the following:

8.1 The disclosure and Conflict of Interest requirements stipulated in the General Code of Conduct are applied to all product types, including Third Party Portfolios, to ensure consistent application.

8.1.1 It is critical for FSPs to have a thorough understanding of all potential instances of Conflict of Interests that may arise when rendering financial services on Third Party Portfolios in order for the conflicts to be dealt with in accordance with the relevant provisions in the General Code of Conduct.

8.1.2 FSPs who earn remuneration as a result of business placed with the CIS Manager and do not pass it on to their clients, must comply with section 3A of the General Code of Conduct and in particular section 3A(1)(a)(iii) which stipulates that the client must be informed of this arrangement and consent obtained.

8.1.3 Before rendering a financial service in respect of Third Party...
Portfolios, the FSP must comply with regulatory requirements to ensure that the client is provided with adequate and appropriate information in order to make sure that the portfolio is suitable. These requirements include the FSP spending time discussing the client’s circumstances and investment needs before recommending their own portfolio.

8.1.4 FSPs must compile and retain documentation to confirm their assessment of the clients’ circumstances and the appropriateness of the Third Party Portfolio recommended.

8.1.5 FSPs must also confirm in writing to the client that due to the nature of the business of the Third Party Portfolios, they recommended their own portfolio(s) only and did not consider other portfolios available in the market.

8.1.6 FSPs must also disclose and confirm to clients where their Third Party Portfolio stands in performance rankings over relevant periods of time (e.g. bi-annual, annual, 3 year and 5 year basis) when compared with other portfolios within the same category and the client must consent in writing to invest in the particular portfolio.

8.2 Coupled with the requirement to disclose Conflicts of Interests is the requirement to adequately and transparently disclose all types of fees clearly to enable clients to consider the impact of these fees on their investments.

8.2.1 All fees levied against Third Party Portfolios must be disclosed in the FSPs’ documentation, brochures and marketing material.

8.2.2 The TER document relied upon by some FSPs may be used to disclose portfolio fees in addition to the FSP’s own documentation containing information such as FSP’s advisory fees, risks and other disclosures contemplated in the General Code of Conduct.

8.2.3 The fees levied by and in respect of Third Party Portfolios must be disclosed as maximum charges, as a range of charges or in percentage terms.

8.2.4 The methodology for determining the value of the fees must be disclosed in the FSP’s documentation and explained to the client.

8.2.5 FSPs must disclose to clients whether fees will be deducted from the investment amount; or will be recovered from returns on the investment; or from redemption of units.

8.2.6 The fees must be explained to the client in detail prior to the client signing any documentation.

8.2.7 In respect of Third Party Portfolios that are Funds of Funds, the anticipated aggregate fees levied against the Third Party Portfolio and by the underlying portfolios must also be disclosed.

8.2.8 The bundled “all-in fee structure”, must be unpacked for the clients’ benefit and FSPs must disclose and explain fully what amounts are being paid to which parties and for what purpose.

8.2.9 The FSPs must disclose all parties to the Third Party Portfolio and their role. The FSPs must also disclose their relationship with all parties to the agreement.

8.2.10 Performance fees must be disclosed separately. This is to enable clients to distinguish between fees that may be levied to a Third Party Portfolio regardless of its performance, as performance fees
may vary significantly each year.

8.2.11 The FSP must provide regular performance feedback to clients invested in Third Party Portfolio(s) and must continue to explain the fees and the impact that these may have had on the investment.

8.2.12 Any changes to the portfolio’s fee structure and FSP’s additional fees must be communicated properly to the clients and the clients must be given adequate notice period (no less than 3 months) to review the new fees prior to increasing or implementing them.

8.2.13 The FSP must make it explicitly clear that fees may be levied if the client requests a new or enhanced service that is not contemplated by the current fee structure.

8.3 The manner in which fees and/or conflict of interests is disclosed to the client can be done in a number of ways. The FSP must demonstrate that the client was notified of and has received all the necessary information when rendering financial services on Third Party Portfolios.