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SFC
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Report of the Survey on Fund Trading Practices (Market Timing, Late Trading and Selective Disclosure) for the Period 2002 – 2003

就 2002 – 2003 年期間的基金交易慣例 (選時交易、逾時交易及選擇性披露)的調查報告

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Report of the Survey on Fund Trading Practices (Market Timing, Late Trading and Selective Disclosure) for the Period 2002 – 2003

Background

1. In the first quarter of 2004, the Commission conducted a survey with licensed corporations that carry out fund management or advisory business in Hong Kong, with a view to collecting general information about fund trading practices in Hong Kong (the "Survey").

2. The Survey forms part of the SFC's overall regulatory efforts to examine current market practices in relation to fund management. The Survey is focused on market timing[1] and late trading and the extent to which funds managed or advised by SFC licensed fund managers or advisors may be subject to such fund trading practices. The Survey has also collected data on policies adopted by these licensed corporations on selective disclosure of portfolio holdings.

3. Given the focus is to gather information about market timing and late trading, only information in relation to open-ended funds (i.e. funds whose units are capable of being subscribed or redeemed at regular intervals) is relevant to the analysis in this Report. Accordingly, the findings in this Report are based on information collected from 86 respondent firms which were carrying on the business of managing open-ended funds ("Respondents").

4. The Survey covers fund trading practices of the Respondents during the period from 1 January 2002 to 31 December 2003 (the "Period").

[1] While "market timing" is not a precisely defined term, it generally refers to a trading strategy, often coupled with frequent purchases and sales of units/shares, in open-ended funds with the intention of anticipating changes in market prices.

Report Findings

A. Market Timing

Highlights

- Respondents were considered to be open to abuses by market timers if their funds contained portfolios of global securities. About 48 Respondents fall within this category and are referred to as "Selected Firms" in this Report.
- Of the 48 Selected Firms, 24 firms (whose AUM[2] for open-ended funds represented about 90% of the total AUM reported by the Selected Firms) monitored market timing. Nearly all of these firms also monitored trading activities of nominee accounts so as to detect and prevent market timing.
- The remaining 24 firms did not monitor market timing because they believed their funds were not attractive to market timers due to reasons attributed to composition of portfolios, investment strategies or less frequent dealing frequency of their funds.
- Nevertheless, Selected Firms adopted a wide variety of preventive measures to deter and reduce the risks of market timing though these do not represent a set of standardised measures that the market has followed.

Selected Firms that monitored market timing ("Group I")

5. The Survey finds that 24 Selected Firms actively monitored market timing ("Group I Firms"). Group I Firms are mainly established fund managers whose AUM for open-ended funds represented about 90% of the total AUM managed by the Selected Firms.

6. 18 Group I Firms monitored market timing activities by themselves while the remaining 6 firms monitored through third parties e.g. administrator. Nearly 90% of Group I Firms monitored trading activities in the nominee accounts of fund investors.

7. There is a diverse range of measures that these Group I Firms employed to monitor market timing. Measures that were employed by these firms include:

   (a) monitoring of frequency or size of transactions conducted by investors;
   (b) analysing trading trend and pattern of investors; and
   (c) trade blocking for investors whose trades exceed a pre-determined threshold.

[2] AUM means assets under management.

8. 12 firms reported unusual frequent trading[3] during the Period in the Survey. Although the Survey did not request the Respondents to provide reasons for such transactions or details as to the follow-up actions taken by the firms, 8 firms voluntarily provided that information. Sometimes, fund managers noted a phenomenon of frequent trading which, upon further enquiry, was revealed as trades conducted on an aggregated basis at the level of an omnibus or nominee account for and on behalf of a large number of genuine underlying investors. In other circumstances, fund managers would take one or more of the following actions to guard against abusive practices:

(a) issue "warnings" to clients who conducted market timing;
(b) request their clients to reduce their tradings;
(c) prohibit further subscriptions or switching of funds by such clients; and
(d) turn away investors who were suspected to be market timers based on the firms' internal risk monitoring parameters.

9. 2 firms that offered retail funds in Hong Kong also indicated that market timers had approached them during the Period to enable these investors to market time their funds. These approaches had been rejected.

Selected Firms that did not monitor market timing ("Group II")

10. Group II are the 24 Selected Firms that did not monitor market timing activities. Firms in Group II mainly explained that dealing of their funds was subject to oversight by other parties or that they believed it was not necessary to monitor market timing for their funds in light of the funds' specific investment structure and strategy. Examples of the funds' specific structure or strategy are:

(a) index tracking exchange-traded funds with a continuous creation and redemption of units on an intra-day basis and their trading price is transparent through continuous trading in the secondary market;
(b) dealings of the funds are at infrequent intervals such as bi-weekly or monthly basis; and
(c) MPF funds where investors are mostly employees making monthly contributions to MPF schemes.

11. Although these firms might not have a formal monitoring mechanism over market timing activities or otherwise did not set out purposely to monitor these activities, most of the Group II firms adopted one or more types of measures that are capable of being used to create deterrent effect on market timing activities.

[3] As the Survey is designed to solicit information from the fund industry, hence it has not prescribed a definition for "unusual and/or frequent trading". These firms have relied on their own pre-determined parameters that they have adopted (based on their operational needs) in detecting unusual trading.

Measures adopted by Selected Firms to deter or reduce the risks of market timing

12. The Survey finds that 42 Selected Firms have adopted one or more of the policies or procedures below to deter or reduce the risks of market timing:

    (a) 19 of the Selected Firms who are mainly fund managers with international operations, adopted a fair value pricing policy[4]. However, responses from these firms indicated that they had rarely relied on the policy during the Period to re-value their funds.

    (b) 38 of the Selected Firms had in place one or more of the following measures:

    - Imposition of sales and redemption charges
    - Discretion to reject, limit or delay a transaction
    - Dual pricing model (i.e. imposition of a bid/offer spread between a fund's subscription and redemption price)
    - Discretion to restrict excessive trades in terms of volume/number of trades

    (c) Other measures include the imposition on investors certain minimum holding period, dilution levy, redemption notice period and the requirement of redemption in specie for large deals etc.

Observations on market timing

13. Market timing is not found to be a widespread phenomenon in light of the small number of firms which had noticed unusual frequent trading other than omnibus account trading and the low frequency of approaches made by market timers to local fund management companies during the Period.

14. One possible explanation offered by some Selected Firms for the less severe market timing activities in Hong Kong is that most Hong Kong managed funds were investing in Asian securities and the time difference for market closing between various Asian markets is relatively narrow, thereby creating less incentives for time arbitrage.

15. Large and established firms in Hong Kong are likely to put in place a monitoring system for market timing activities and have taken measures to reduce the risks of being market timed by investors. However, there is no one single set of standardised measures that the market has been using to prevent possible frequent trading by investors.

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[4] In the Survey, firms were asked whether they had in place practices/policies/mechanism for making an appropriate adjustment to fund valuation to reflect more accurately the current value of the portfolio of securities held by their funds.

This question was posed in light of the fact that where a fund is valued using prices from a market which is closed for a particular day, or due to time zone differences, closed for normal trading at a time materially prior to the fund valuation point, and where subsequent events indicate that prices are likely to move significantly when the market re-opens, fund managers may, in certain circumstances, wish to undertake certain pricing adjustment.

B. Late Trading

Highlights

- More than 3/4 Respondents (65 firms) had stated policies or controls regarding the timing and receipt of fund orders from retail clients and distributors after the dealing cut-off time. As to the remaining 1/4 (21 firms), some had their administration functions undertaken by third parties, e.g. administrator, while the others said that due to the nature of trading of their funds (e.g. exchange traded funds with continuous dealing, MPF funds with monthly dealing and pre-determined allocation), such policy might not be necessary.

- 10 Respondents indicated that they had allowed deviations from the prescribed policies/controls and these were mainly done under very limited circumstances (e.g. failure of IT/telecom /fax systems of the intermediaries or their own systems) and with independent or management approval.

Observation on late trading

16. The Survey does not find late trading (i.e. placing of deals after the valuation point of the fund at a known price) a pervasive practice in the local fund industry. Although a small number of Respondents that adopted forward pricing policies had, in some circumstances, not been able to adhere strictly to their own collection deadline for orders from investors or distributors, these firms could still maintain that such orders received could be processed on a forward pricing basis.

C. Selective Disclosure of Non-public Information of a Fund's Portfolio

Highlights

- More than 2/3 Respondents (59 firms) indicated that they had in place a policy governing disclosure of non-public information with respect to the portfolio holdings of their funds. Some of the remaining Respondents explained that although they had no prescribed policy on the issue, in practice, they did not allow selective disclosure.

- 4 Respondents were approached by potential or existing clients for disclosure of non-public information. While two of them refused the proposals, the other two disclosed their funds' portfolio holdings under restricted circumstances to institutional investors or analysts in that the disclosure was made subject to confidentiality agreements with the recipient of the information.

Observation on selective disclosure

17. The Survey finds that most of the Respondents had in place a policy governing selective disclosure of non-public information on funds' portfolio holdings. Yet there was no standardised practice towards selective disclosure. Thus there might be an area of concern if some investors (whether institutional clients or retail clients) were provided with non-public fund information but others were not.

D. Oversight and Independent Review of Funds' Activities

<u>*Highlights*</u>

- More than 90% Respondents (80 firms) had the policy that the dealing and administrative arrangements of their funds were subject to the oversight of one or more independent bodies such as compliance departments of fund managers, trustees of funds, external auditors, and third party administrators etc.
- About 1/3 Respondents (24 firms) indicated that their internal audit or compliance departments had recently performed reviews with respect to late trading and frequent short term trading activities.

Observations on fund oversight

18. It appears that the majority of the funds managed by the Respondents were subject to a certain degree of oversight with respect to the dealing and administrative activities performed either by the fund managers themselves or external parties.

Conclusion

19. The SFC notes that market timing, late trading and selective disclosure of non-public information by fund managers have attracted attention at the international fund industry level. While market timing is not illegal, the conduct of market timing in conjunction with other practices such as trading on non-public information and exploiting time arbitrage by way of late trading, may act to the detriment of long-term investors in a fund.

20. The Survey does not find market timing a widespread phenomenon in the Hong Kong market. However, there were two instances where market timers had made approaches to fund managers offering retail funds in Hong Kong to explore possible market timing opportunities. Most well-established fund managers in Hong Kong have maintained a certain degree of surveillance over market timing activities although the preventive measures they adopted vary according to their internal policies and modes of operations.

21. Late trading does not appear to be prevalent in Hong Kong as nearly all respondent firms confirmed that they strictly adhered to the collection deadlines for subscriptions/redemption orders. Some firms indicated that they had allowed deviations from their collection deadlines on certain occasions and attributed these to administrative reasons such as failure of transmission or IT systems of distributors or investors. However, these firms were still able to maintain that such orders received could be processed on a forward pricing basis.

22. The Survey also reveals that there were no unified policies adopted by the fund industry to deal with selective disclosure of non-public information relating to a fund's portfolio. Some fund managers imposed a policy to ban outright selective disclosure while others might, in restricted circumstances, selectively disclose a fund's holdings upon client's requests.

23. The Survey is the first wide-scale survey with licensed fund management companies on their trading practices. There are areas that the SFC believes should be followed up to enhance understanding of the market practice. The Commission will perform further review of the fund trading practices and will also discuss the issues covered in the Survey with the industry to work out possible means to guard against abusive trading practices.

24. Since Hong Kong serves as a key fund management centre for both local and overseas funds, the SFC will work together and share information with other securities regulators in leading fund management centres in relation to fund trading practices and other aspects of fund management regulation.