



**ASIC**

Australian Securities & Investments Commission

REGULATORY GUIDE 94

# Unit pricing: Guide to good practice

August 2008



# Unit pricing Guide to good practice

Joint ASIC and APRA guide  
Updated August 2008



## Copyright

© Australian Prudential Regulation Authority and Australian Securities & Investments Commission (2008).

The material in this publication is copyright. You may download, display, print or reproduce material in this publication in unaltered form, for sale or otherwise, conditional upon acknowledging ownership of content by the Australian Prudential Regulation Authority (APRA) and the Australian Securities & Investments Commission (ASIC), for example: '© Australian Prudential Regulation Authority and Australian Securities & Investments Commission. Reproduced with permission.' Apart from any use as permitted under the *Copyright Act 1968*, all other rights are reserved.

Requests for other uses of the information in this publication should be directed to APRA Public Affairs Unit, GPO Box 9836, Sydney NSW 2001 or [Public.Affairs@apra.gov.au](mailto:Public.Affairs@apra.gov.au) and [feedback@asic.gov.au](mailto:feedback@asic.gov.au)

## Disclaimer

While APRA and ASIC have published this publication in good faith based on the facts we are aware of at the time of publication, neither APRA nor ASIC accept any responsibility for the accuracy, completeness or currency of the material included in this publication, and will not be liable for any loss or damage arising out of any use of, or reliance on the material in this publication.

This publication is meant to be a general guide and you should form your own views as to its application.

Australian Securities & Investments Commission, GPO BOX 9827, Sydney NSW 2001

Australian Prudential Regulation Authority, GPO Box 9836, Sydney NSW 2001

First published: 2005

ISBN: 0-646-45372-6



## What this guide is about

### APRA/ASIC review of unit pricing practice

Both APRA and ASIC have regulatory jurisdiction for aspects of the practice of life companies, superannuation providers and fund managers. After noting concerns about unit pricing practice in these entities in recent years, we undertook a joint review of unit pricing practice from July to December 2004.

The review built on the prior work of both regulators, examining instances at more than 40 entities where unit pricing issues have been addressed since 2000. We also visited product issuers and service providers and consulted with industry bodies to obtain current views on unit pricing and outsourcing practice.

The review included a survey of aspects of unit pricing, outsourcing and tax practice that was sent to 95 entities. The response rate overall was high at 85%. We received replies from 29 operators of managed investment schemes (93% response rate), 16 life companies (100%) and 36 superannuation funds (80%).

The regulators' findings in the joint review were by no means all bad news. Substantial evidence was found of entities that had clearly recognised and were managing the risks associated with unit pricing, and where the complexities of operating a unit pricing methodology were approached with care and diligence. For the thousands of unit prices calculated by industry each day, most will be correct, or if found to be in error will be quickly corrected. However, a small number of undetected errors can give rise to problems.

In December 2004 we published a joint consultation paper on good practice in unit pricing, based on the findings of our review. We received 16 detailed submissions in response and have considered those comments in the development of this guide.

Our survey process, the development of the consultation paper and the further refinement of parts of this guide were subject to independent review by an external consultant.

We would like to acknowledge the contribution of industry participants and industry bodies to the development of both the consultation paper and this guide.



## Status of this guide

We are not of a view that there is only one preferred way to address unit pricing issues, and we have noted a range of industry conduct that has the characteristics of good practice.

This is therefore a guide to ‘good practice’ – not a guide to ‘best practice’ nor a mandatory set of instructions.

Some of the material in this guide is a reminder of current legal obligations, while some is a reminder of policy and other guidance we have published. Other material describes good practice as observed among industry participants. Much of the material outlines a common sense approach, building on the obligation to treat unit holders equitably.

Many of the matters raised in this guide have come to our attention following recent unit pricing issues. However, the range of matters that product providers need to consider in managing unit pricing is not necessarily limited to, or fully covered by, this guide.

We will continue to review aspects of unit pricing practice as part of our ongoing regulatory monitoring. In doing so, we will expect to find:

- sound understanding of good practice in unit pricing demonstrated at all levels of regulated organisations, and
- a strong commitment to the implementation of effective unit pricing practice.

We will also expect that product providers’ unit pricing practices will measure up with the practices described in this guide. There may be unusual circumstances in which alternative practices are appropriate. In such cases, we expect that product providers will have a reasonable and documented justification for adopting alternative practices.

## Scope of this guide

APRA and ASIC have developed this guide to help product providers understand and comply with their unit pricing obligations. The guide may also help entities considering whether to unitise their products.

The guide does not specifically address crediting rate practices, which are another way of attributing investment returns from a pool of assets to members of the pool. However, some of the issues raised and practices outlined in this guide are also relevant to crediting rate practices.

Chapter 1 outlines strategic unit pricing issues to be considered by the board and senior management. Chapter 2 identifies good practice principles that should underpin the unit pricing practice of all product providers.



The body of the guide (Chapters 4 to 6) describes the application of the good practice principles in relation to a range of important management, technical and consumer matters. Each section of these chapters outlines a particular unit pricing issue and concludes with guidance on good practice.

Key terms used in the guide are defined in Chapter 8 at the end of the guide.

### **Updates to this guide**

We will consider updating this guide from time to time. If you would like to comment on matters discussed in the guide, please send your comments to both:

#### Review of Unit Pricing Guide

APRA  
GPO Box 9836, Sydney NSW 2001

ASIC  
GPO BOX 9827, Sydney NSW 2001

or email:

[unitpricingguide@apra.gov.au](mailto:unitpricingguide@apra.gov.au)

[unitpricingguide@asic.gov.au](mailto:unitpricingguide@asic.gov.au)



In this guide, references to laws, including regulations and sections of acts, are references to those laws as at the date of this guide.

This page has otherwise been intentionally left blank



## Contents



	page
<b>1 Strategic unit pricing issues for the board and senior management</b>	<b>8</b>
<b>2 Good practice principles for unit pricing</b>	<b>14</b>
<b>3 Pooled investments – unit pricing and crediting rates</b>	<b>18</b>
<b>4 Management issues</b>	<b>21</b>
4.1 Effective risk management culture	21
4.2 Unit pricing issues common to many products	30
4.3 Additional unit pricing issues for products with complex structures	38
4.4 Managing diversity in systems and products	41
4.5 Managing change	44
4.6 Outsourcing unit pricing functions	48
<b>5 Technical issues</b>	<b>56</b>
5.1 Determining asset values	56
5.2 Determining tax treatments	63
5.3 Determining the use of reserves	72
5.4 Applying accounting standards	76
<b>6 Consumer issues</b>	<b>80</b>
6.1 Providing information about unit pricing	80
6.2 Managing complaints	87
6.3 Managing errors and compensation	90
<b>7 Obligations relevant to unit pricing</b>	<b>99</b>
<b>8 Key terms</b>	<b>102</b>



## Strategic unit pricing issues for the board and senior management

### Focus on unit pricing issues

Unit prices are often calculated in a high-speed, high-pressure environment. Your organisation may calculate and publish many hundreds of unit prices every day. Even if you only calculate a smaller number of unit prices weekly or monthly, you still face considerable pressure to obtain timely, if less frequent, information and to ensure consistency and accuracy in your operations.

**!** You need to consider the following strategic unit pricing issues to ensure that your organisation measures up to industry good practice.

We discuss these issues in more detail in the remainder of this guide and outline good practice in relation to them.

### Errors in unit pricing can be costly

**!** When large errors arise they tend to be very large indeed.

There have been instances of errors costing more than \$10 million in compensation. The associated costs of rectification can also be substantial, as can the consequences of reputational damage or publicity. As a senior manager or member of the board, it is therefore important to get unit pricing right.

### Give unit pricing a high profile and resources

**!** To avoid costly errors ensure that unit pricing in your organisation has a high profile and adequate resources.

In each budget cycle you need to consider the resources required for unit pricing and ensure they are at the appropriate level.

You also need to determine the appropriate level of board and senior management involvement in unit pricing issues, including endorsement of policies and the implementation of a unit pricing policy framework.

### Comply with your legal obligations

At all times you are subject to a wide range of duties.

**!** In particular, in all cases you need to act honestly, diligently and impartially and in the best interests of all unit holders.



## Build an effective risk management culture

**!** You need to build an effective risk management culture in your organisation from the top down.

The board and senior management set the tone and approach. Your attitude to risk management is the major determinant of the likelihood and impact of unit pricing errors. Significant errors have arisen, and have continued undetected, where the approach to risk management has been inadequate.

**!** You also need to demonstrate your commitment to risk management.

This may be done by setting policy, monitoring performance and leading risk management committees. In such ways your staff and professional advisers are more likely to see risk management as a high priority for your organisation.

**!** Your risk management systems should include controls, monitoring and reporting, so that unit pricing errors are avoided or quickly identified.

The more effective your risk management systems, the more likely it is that errors will be avoided or quickly identified. The sooner an error is detected and resolved, the lower the potential cost and reputational damage to your organisation.

**!** You need to support and encourage staff and professional advisers to report issues, incidents and exceptions.

## Establish a policy framework

**!** You need to take responsibility for developing and implementing a unit pricing policy framework for your organisation.

Your policy framework needs to cover all of the management, technical and consumer issues identified in this guide. It should also include policy and procedures for managing any unit pricing errors that arise and for addressing rectification and compensation issues.

**!** Implement the policy framework in such a way that your unit pricing policies are discussed, understood and applied consistently throughout your organisation.

Implementation should include regular monitoring to ensure that your policies are updated as required.



## Maintain robust systems and processes

**!** You need to have reliable unit pricing systems, procedures and controls in place, as well as business continuity and disaster recovery plans.

Where possible, avoid manual systems and upgrade your old information technology systems. Old systems require significantly greater controls and maintenance, as well as viable interfaces with up-to-date systems. You also risk loss of critical knowledge and skills as old systems become obsolete.

**!** Your unit pricing systems and procedures need to be well designed and well understood, and should be reviewed periodically.

End-to-end process maps and end-to-end maps of unit pricing controls may be useful, particularly when developed by the people involved in unit pricing functions.

**!** Your systems and procedures should include measures to minimise the likelihood of unit pricing errors.

This includes applying reliable cross-checks to data before it is used in calculations and reviewing valuation methodologies.

## Design effective reports for monitoring

**!** You need to ensure you receive appropriate and timely information on unit pricing issues.

The reports you receive should focus on key unit pricing measures and show the cumulative impact of unit pricing issues arising in different parts of your organisation.

**!** If you are not kept adequately informed then you cannot manage the risks.

## Establish clear delegations and accountabilities

**!** You need to ensure responsibility for each function in your organisation is allocated to a designated person.

Depending on the nature and scale of your operations, the range of functions impacting on unit pricing will probably include:

- Product development
- Marketing
- Unit pricing operations



- Information technology
- Tax
- Accounting
- Legal
- Compliance
- Risk management
- Outsourcing management
- Internal audit.

**!** Your end-to-end process map should completely describe all business activities that can impact on unit pricing.

## Manage complexity and diversity

**!** If you choose to offer complex products or a diverse range of products, or if you operate with diverse systems, then you must ensure that you appropriately manage all aspects of your operations.

Some unit pricing issues are common to most products. However, unitised products are numerous and diverse. A single provider may administer many different unitised products offering a variety of investment choices. Many products and investment choices may no longer be actively marketed to new investors, yet they still need to be administered. Some unitised products invest in other unitised products.

Multilayered products and the use of performance fees add complexity to unit pricing decisions and management.

Diversity in information technology systems and in product range constrains simplification and standardisation.

**!** Extra layers of complexity require greater commitment to implementing effective systems and procedures and greater attention to risk management.

## Manage change effectively

**!** Many unit pricing errors arise as a consequence of change.

Some change occurs in the external environment, while other change is driven by the board and senior management implementing strategic direction, such as takeovers, downsizing or relocation. Other change, such as changes in policy, investment strategy, fees or product documentation, comes about during normal business operations.



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

**!** You need to attend to risk management during periods of change, particularly where there is more than one change or where change arises frequently.

Where possible, schedule the implementation of change to avoid reporting and other peak periods, when business workloads may affect the success of the change program.

**!** You should also implement project management policies, planning and reporting systems to approve, monitor and control change.

You need to assess the effect of proposed change on unit pricing and need to involve unit pricing staff as early as possible.

## **You are responsible for outsourced functions**

**!** While you can outsource some of your functions, remember that you cannot outsource your responsibility for those functions.

You need to decide which functions will be outsourced and be satisfied that all aspects of the end-to-end unit pricing process are addressed in outsourcing arrangements.

The outsourcing agreement must include arrangements for service levels, reporting, determining the extent of liability, dispute resolution, error and complaint management, business continuity and disaster recovery and termination of the agreement.

**!** You need to build and maintain effective working relationships with service providers, maintain appropriate knowledge and build and maintain appropriate monitoring systems.

Meet periodically with service providers to understand the effect any proposed strategic change will have on unit pricing functions.

## **Be prepared to manage errors and compensation**

**!** Regardless of the quality of your systems and controls, unit pricing errors may occur – you need to be ready to deal with them.

When an error has been identified, all your attention needs to be directed to limiting damage and addressing the loss to investors. At that stage it is too late to be establishing general processes to deal with errors.



**!** You need rectification and compensation procedures in place so that they can be applied promptly.

These should be applied consistently and in good faith so that current or former unit holders are not disadvantaged. You should also give priority to preventing recurrence of the error.

**!** Communicate with the regulators as soon as possible after you detect a unit pricing error.

Independent review by external experts is likely to be important in helping you quantify errors and rectify your systems and may help you to avoid errors in the future.



## Good practice principles for unit pricing

The following good practice principles should underpin the unit pricing practice of all product providers. In Chapters 4 to 6 of this guide we consider the application of these principles in relation to a range of management, technical and consumer issues.

We will consider ‘substance over form’ when examining particular instances of conduct.

### 2.1 Unit pricing policies and practice must be consistent with the governing documents for each product

Your policies and practices need to be consistent with the governing documents for each product and your PDS or offer documents.

Some unit pricing errors have arisen because the calculation methodology did not match statements in the product’s governing documents, rather than because the unit pricing methodology was intrinsically faulty. Examples of these include errors in asset valuation and transaction cost methodologies and errors in fee and tax treatments.

To the extent that implementation of good practice is currently constrained by the governing documents, you need to update the governing documents where possible and, as the opportunity arises, align them with good practice.

Governing documents for new products need to be written to take account of guidance for good practice in unit pricing.

### 2.2 Sound unit pricing policies should be implemented consistently and kept up-to-date

#### Policies

Your unit pricing policies need to seek to achieve equity between unit holders.

You need to develop soundly based policies that cover the range of reasonably foreseeable circumstances, including sudden changes in the environment.

You must explain any relevant methodologies and assumptions, and why the assumptions are appropriate and reasonable. This includes explanation of the use of judgement and estimates.



You need to specify delegation levels for decisions and approvals.

Where unit pricing functions are outsourced, you remain responsible for the policies adopted. Maintain a register of key service provider policies and review those policies periodically.

### Procedures

You need to develop procedures to ensure that your unit pricing policies are implemented consistently, including in circumstances where the policies require the exercise of judgement.

Your procedures should be developed by operational unit pricing staff in consultation with staff from other relevant functional areas.

You need to monitor and report internally on the use of these procedures.

### Review

You need to review your policies and procedures periodically, and update them in line with changed circumstances – for example, changes in market conditions, legislation or strategic direction.

### Documentation

Documenting policy and procedures promotes efficiency and consistency and assists in managing risk.

Documenting your policies and procedures will also help you demonstrate, both internally and to the regulators, that your approach and your systems are soundly based and appropriate.

Remember that documentation does not replace individual vigilance.

## 2.3 Adjustments to unit price, if based on sound policy, are not errors

In considering whether compensation is required when you make an adjustment to a unit price, it is essential to consider whether the unit price being adjusted was developed in accordance with soundly based and appropriate policies that were applied consistently.

For example, where estimates included in a unit price need adjustment as the actual amounts become known, or where a reasonable policy is nonetheless reviewed from time to time and updated, neither the unit price before the change, nor the unit price after the change, is incorrect for the purpose of deciding whether compensation is required.



Where such a change is to be made to a unit price, 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 policy has been or is inappropriate or where the application of policy has been or is deficient.

## 2.4 Judgement may be applied to develop estimates in some circumstances

You should not use estimates where actual values are available. However, we recognise that in some cases there is no alternative but to use estimates – for example, in relation to some aspects of tax provisioning.

Your estimation policies, like your other policies, should seek to provide equity to unit holders and potential unit holders.

Your development and use of estimates needs to be consistent with the legal obligations that apply to you, the rules that govern the operation of the product and relevant policies.

If you are using estimates, you should develop these on the most sound and reasonable basis available at the time. You need to be able to justify why the use of an estimate is appropriate in the circumstances and that the estimated value is reasonable.

You need to adjust amounts initially estimated as soon as information on the actual position becomes available. You should also test estimates periodically for robustness using actual data.

## 2.5 Information for unit holders should be accessible, timely and useful

You are subject to a range of obligations to provide information. For example, there are specific obligations to provide PDSs and periodic statements to unit holders.

You may also provide information to unit holders to meet other obligations, or voluntarily.

Where there is no specific obligation on you to provide information, but you decide it is consistent with your broader obligations to do so, we expect that you will make this information available in an appropriate form. Depending on the circumstances, you may use channels such as websites, call centres or correspondence, or include information in documents provided under statutory obligations.



Information must be expressed in terms that unit holders will understand.

The Good Disclosure Principles in ASIC Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* [RG 168] provide a useful checklist:

1. Disclosure should be timely
2. Disclosure should be relevant and complete
3. Disclosure should promote product understanding
4. Disclosure should promote comparison
5. Disclosure should highlight important information
6. Disclosure should have regard to consumer needs.



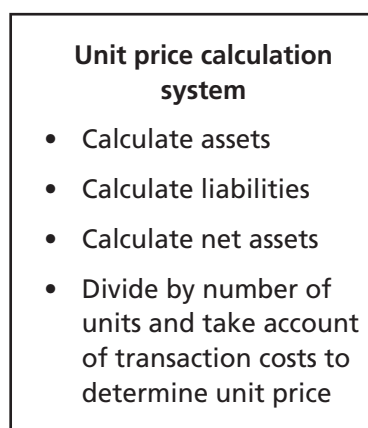
## Pooled investments – unit pricing and crediting rates

People may choose to invest directly in assets such as shares or bonds. Alternatively, they may choose to invest in products where their money is pooled with the money of other people. The investment assets acquired with this pooled money are managed on behalf of all the investors.

Unitisation is a way to equitably attribute a share of the value of pooled products to investors. 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 Figure 1 below.

Figure 1: Basic unit price calculation



Another method to attribute a share of the value of pooled products is the use of a crediting rate. An amount is credited to each person's account based on the overall rate of return on 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, or closer to, the time unit holders acquire or dispose of products. Unit pricing avoids transferring investment returns between entering, leaving and ongoing unit holders (generations of unit holders). That is, unitisation may be perceived as providing more transparency and resulting in more equitable treatment of beneficiaries and fund members.



However, 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.

Unit prices also fluctuate with changes in asset values and investment returns. Where unit prices are calculated frequently there is often greater volatility in the unit price. Returns appear more volatile than for funds using crediting rates.

A number of the issues covered in this guide are relevant to both the unit pricing and crediting rate environments. While this guide focuses on unit pricing issues and practices, the following sections in particular are also relevant for entities using crediting rates:

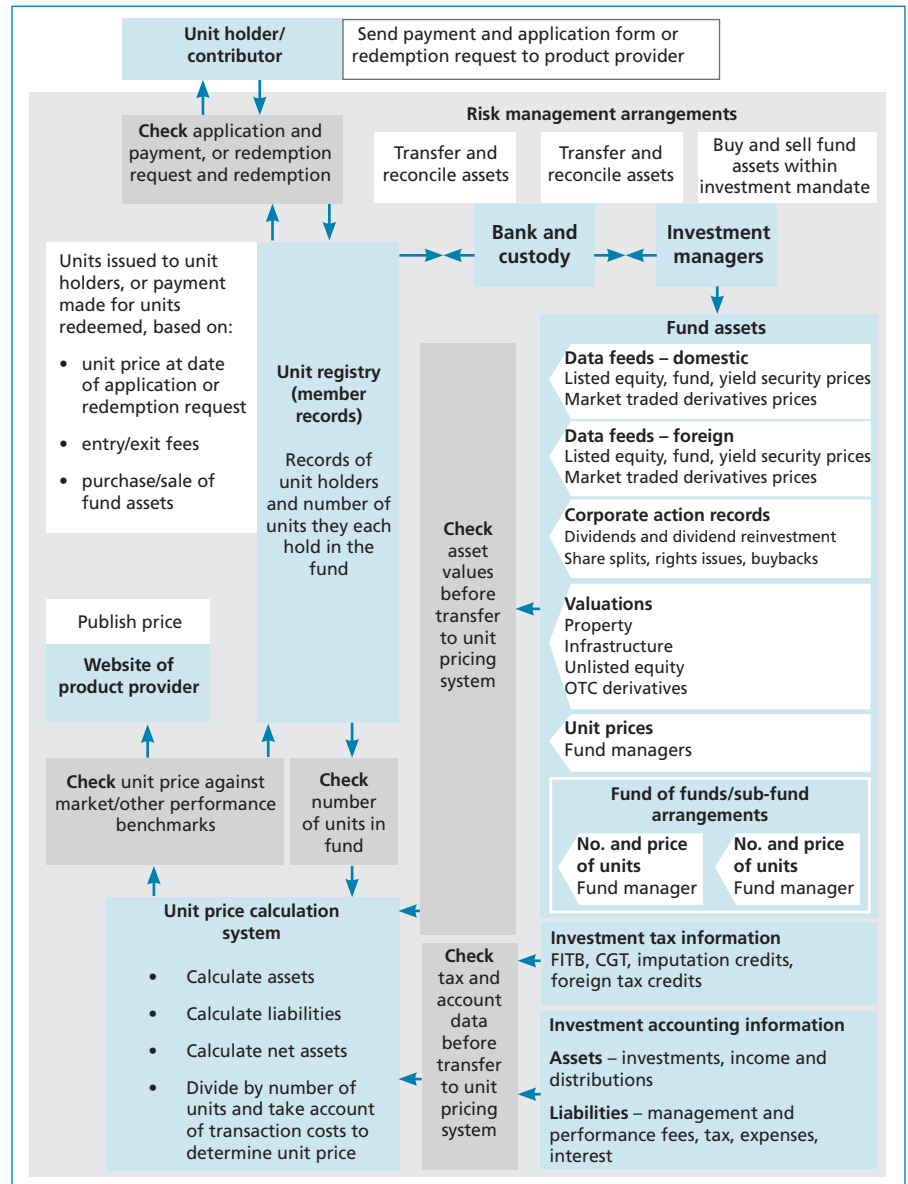
- 4.1 Effective risk management culture
- 4.5 Managing change
- 4.6 Outsourcing unit pricing functions
- 5.1 Determining asset values
- 5.2 Determining tax treatments
- 5.3 Determining the use of reserves
- 5.4 Applying accounting standards.
- 6.3 Managing errors and compensation.

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

Figure 2 below outlines key elements and relationships in the unit pricing calculation cycle. While Figure 1 focuses on the unit pricing calculation itself, Figure 2 illustrates the complexity of the overall unit pricing function, and shows, in the bottom left-hand corner of the diagram, the unit pricing calculation in this context.



Figure 2: Key elements of the 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.

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

Chapter 4 outlines a range of important management issues in unit pricing and includes guidance on good practice. The good practice guidance is presented as boxed text at the end of each section.

### 4.1 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 unitised products.

Unit pricing 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.

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

Responses to our unit pricing survey indicated that risks arise from:

- the timeframes in which unit prices need to be calculated
- tax issues, including reconciliations of deferred and current tax, and determination of values for current tax, deferred tax liabilities, and deferred tax assets
- lack of integration of information technology systems, and the need for manual workarounds
- the need to manage the relationship with the service provider where functions are outsourced
- legacy products and services – for life companies and some managed investment schemes, and
- the need for timely provision of information by external product providers.

#### Role of the board and senior management in establishing risk management culture

The board and senior management set the tone and approach. If they demonstrate commitment – for example, by setting policy and monitoring performance and by leadership of risk management committees – high priority is more likely to be given to risk management throughout the organisation.



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

We have seen significant errors arise, and continue undetected, where an organisation's approach to risk management was inadequate. In the worst cases, there was even failure to identify the risk that errors might occur, or staff were disadvantaged or penalised for reporting problems.

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

### **Attitude to risk management**

Managers and operational staff directly involved in day-to-day unit pricing play a vital role in drawing key unit pricing issues to the attention of senior management and the board.

The effectiveness of an organisation's risk management culture can influence the probability and impact of unit pricing errors more strongly than:

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

### **Identifying the source of unit pricing errors**

Seeking the immediate cause of a unit pricing error may not identify the actual source. Symptoms may be addressed without identifying underlying sources. If piecemeal solutions are implemented, an organisation may continually incur costs of rework, investigation and compensation.

Frequently the problem is a failure to appropriately consider and manage risks such as:

- difficulties in asset valuation
- ineffective product management
- lack of an 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 given to unit pricing resourcing, including the number and seniority of unit pricing staff
- staff morale and productivity issues, including inadequate training
- ineffective project or transition management, and
- pressure to increase competitive advantage by reducing the time to market for new products.

### Key considerations for managing risks in unit pricing

In building an effective risk management culture in your organisation you need to consider:

- How can systems and procedures be built and maintained to eliminate or reduce errors?

When designing your systems and procedures, you should particularly focus on minimising large errors. You also need to consider other issues, including the matters covered in this guide, as relevant to your organisation.

- 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 taken 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. There is a risk that skilled unit pricing staff will be taken 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.

- How can independent review be achieved?

Internal and external reviews need to be taken seriously, and recommendations considered and implemented. An organisation's failure or refusal to implement recommendations is a clear indication of a poor attitude to risk management.

Early identification of errors followed by thorough investigation and rectification action can significantly limit the impact of problems in unit pricing systems or procedures. Systematic analysis of customer complaints



and feedback may help to identify problems quickly.  
For more information see section 6.2, 'Managing complaints'.

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 (AFS) licence need to address such issues in their risk management plans.

### Accountability to unit holders

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 for managing the risk of administrative error whether you invest directly in the market or through other product providers (for example, by investing in managed investment schemes). You should select product providers who themselves manage administrative risks effectively. In particular, you need to be wary of accepting limitations on service provider liability.

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.



## Guide to good practice in effective risk management

### Build and maintain an effective risk management culture

The need for an effective risk management culture is a constant theme of this guide.

The board and senior management cannot be expected to understand every process at a detailed level. Nevertheless, they should 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, your risk management systems and procedures are likely to include:

- clear delegations and accountabilities



## Guide to good practice in effective risk management (cont.)

- formal identification, assessment and rating of risks
- formal identification of mitigating factors, with assessment and rating of their effectiveness
- monitoring controls embedded in unit pricing processes – for example, measurement of movements outside acceptable ranges, tracking of prices against benchmarks, and the use of key risk indicators to measure and monitor operational performance and to control quality
- 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 matters. Reports need to provide integrated information to the board and senior management about the effectiveness of risk management and about emerging issues. Effective reporting allows the organisation to learn about risk management. The systems themselves cannot solve problems, however they do tell management what is important. Reports need to address:
  - exceptions (what is not working as expected)
  - movements outside agreed tolerance levels (a number, a dollar amount, and measure of impact)
  - reassessment of measures – changes to ratings need to be reported and explained, and
  - regular identification and reporting of new risks
- consideration of the number of service providers. Information may be received by the product provider at different times and in many different formats. The greater the number of systems, the greater the number of controls required to ensure that all relevant information is obtained and integrated into the reports. Ideally the number of service providers would be kept to a minimum
- 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



## Guide to good practice in effective risk management (cont.)

- 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, your risk management for unit pricing should include:

- board and 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 the board and senior management give to resources for unit pricing
- support and encouragement for staff to report incidents and exceptions. According to Australian Standard AS 3806–1998 *Compliance programs* (paragraph 3.3.8): ‘Staff should be encouraged to respond and report breaches of the law and other incidents of non-compliance, and to see reporting as a positive and non-threatening action.’ We expect entities to establish a similar environment for reporting on risk management
- 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.



## Guide to good practice in effective risk management (cont.)

These lists are not intended to be exhaustive. As product providers, you are responsible for ensuring that you identify, measure, mitigate and manage your business risks.

For further guidance see:

- Australian and New Zealand Standard AS/NZS 4360:2004 *Risk management*
- ASIC Regulatory Guide 164 *Licensing: Organisational capacities* [RG 164], if you are an AFS licensee
- ASIC Regulatory Guide 132 *Managed investments: Compliance plans* [RG 132], if you are a responsible entity or other provider of managed investments, including IDPS, MDA and custodial services
- APRA Superannuation Guidance Note SGN 120.1 *Risk Management*, if you are the trustee of a superannuation fund.

### Training

Everyone participating in unit pricing needs to understand the end-to-end unit pricing process and how their own responsibilities fit into that process. Errors should not arise because 'things fall between the cracks'. Training is essential to build understanding of all the elements of unit pricing and to implement procedures effectively.

Some industry participants have commented that the development of process maps by unit pricing staff is an 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 may also be an effective training tool.

### Document policies and procedures

Documenting your policies and procedures promotes efficiency and consistency, and also assists in risk management by:

- reducing reliance on key individuals



## Guide to good practice in effective risk management (cont.)

- describing checks and tests, clear paths for investigation of errors and reporting/escalation procedures
- providing clear instructions for complaints management, disaster recovery and business continuity. This reduces the risk of 'spur of the moment' decisions
- providing clarity about the authority to exercise discretion
- providing clarity about requirements for review and high-level decisions
- 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 in the process. You should develop and use checklists for this
- describing the evidence of review, such as signed printouts, required for each step/process, and
- assisting product or systems migration, where required.

However, documentation does not replace individual vigilance.

To be effective, your documentation should be succinct and relevant.

Documentation will be simpler to manage where you achieve alignment between your governing documents and your policies and procedures – for example, regarding cut-off times for transactions.

Your documentation should be periodically reviewed and updated. While this can be time-consuming, resources need to be allocated to it. You should review and update your documents when there are changes in:

- your organisation
- the external environment, or
- your systems or products.



## Guide to good practice in effective risk management (cont.)

### Independent review and investigation

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.

Reviews can be undertaken by parties who are not directly involved in the unit pricing function – for example, internal audit, the compliance unit, the risk management unit, external auditors, actuaries or other external advisers.

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.

Our unit pricing survey found that where product providers have audits conducted for unit pricing functions, the focus is on member registry, fund accounting, asset valuation, and fee, tax and unit price calculations. However, member registry and tax calculation functions 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.

Remember that the compliance plans of registered managed investment schemes must be externally audited every financial year (under s601HG of the *Corporations Act 2001*), and the risk management plans and risk management strategies of superannuation funds must be audited annually (under s113(3)(c) of the *Superannuation Industry (Supervision) Act 1993*).



## 4.2 Unit pricing issues common to many products

### Forward pricing or historic pricing

Many product providers use forward pricing to calculate unit prices. 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 use of forward pricing may be limited by governing documents. Old information technology systems or the design of registry systems may also pose a challenge to the use of forward pricing.

An alternative is to use backward or historic pricing. This enables purchases and sales of units using a price calculated before applications have been received – 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.

Where historic pricing is used there is potential for arbitrage – that is, unit holders can buy or sell units to take advantage of the difference between yesterday's price and the subsequent shift in market value. When this happens, a few transacting unit holders benefit to the detriment of all ongoing unit holders.

Fund documents may state that forward prices will be used, whereas we have seen cases where both forward and historic prices were used in practice.

In 2004 ASIC reviewed the investment practices of 70 managed investment scheme operators in Australia following regulatory action regarding market timing and late trading behaviour in the United States. The review found that 84% used forward pricing exclusively while 9% used some backward pricing.

### Many pieces of information are used to calculate one unit price

As shown in Figure 2, '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.

There is a risk of error where data is not checked. For example, commercial data feeds for listed equity and derivative prices may include stale prices, zero amounts, or daily movements outside the usually accepted tolerances. We have also seen incorrect foreign exchange and fee rates applied.



There is also a risk of error when the information used to calculate a unit price is not timely. External product providers may be slow to provide the prices of units in unlisted managed investment schemes. Providers 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.

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

### 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 type and volume of assets transacted. A fund investing in international equities will incur different transaction costs from 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 by the product provider because brokerage costs have not been incurred.

There are a number of ways that transaction costs have been allocated – for example, using:

- the mid-price as a single price 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
- a buy-sell spread, where 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
- the net buyer/seller method, where 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.



We have seen unit pricing errors arise where uncertainty about the methodology has resulted in inconsistent calculation of transaction costs or inappropriate application of transaction costs.

### **Backdating – processing applications other than on the date of receipt**

The practice of backdating – that is, processing applications to acquire or sell units after the date of receipt – may increase the risk of error. For example, the wrong date of receipt may be recorded or the price for the wrong date may be applied. Errors may occur particularly when there are long delays before processing or where many applications accumulate.

Fund documents, including the PDS, may specify rules about the price to be applied when units are issued or redeemed and the timeframe in which applications will be processed.

Unprocessed money (money paid to a product provider to acquire a financial product, where the product has not yet been issued) must be held in trust for the person who paid the money in a designated account until the units are issued: see s1017E of the *Corporations Act 2001*.

### **Manual systems and workarounds**

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

Short-term computer fixes and manual workarounds have been a significant cause of unit pricing errors. We have seen double counting of fees and the use of incorrect rates or incorrect formulae for fees.



### **Guide to good practice in relation to common issues**

#### **Forward pricing or historic pricing**

Forward pricing is preferred to historic pricing. You should take steps to move to forward pricing, where possible. When moving to forward pricing, it is important to consider the matters discussed in section 4.5, 'Managing change'.



## Guide to good practice in relation to common issues (cont.)

Where historic pricing is used, controls should be in place to avoid arbitrage. Some controls that may assist are:

- introducing fees for frequent switching, or a disclosed period of delay to make arbitrage uneconomic
- monitoring and investigating switching activity by investors, and
- conducting market volatility tests so that unit transactions are suspended if markets move by more than a pre-determined amount. This needs to be supported by clauses in the documents setting out fund operating rules that permit suspension and recalculation of unit prices during periods of extreme market volatility.

Where unit prices are calculated less frequently than daily, the use of forward pricing will mean that applications are accumulated in the period leading up to the calculation of the price, and processed as soon as possible after calculating the price.

### Batching

If you use batching, you should process applications and redemptions at the same time you strike the unit price. In our view this is good practice. We encourage you to:

- batch and process on the day, or the day after, the price is calculated, and
- make reasonable efforts to ensure that any return earned on unprocessed funds is attributed to the investor.

If batching is not possible, a less preferred option is to accumulate applications in the period before the price is struck, and process those applications in the period after the price is struck. In this case, you would need to include in the amount invested for each applicant any investment earnings accrued in the intervening period.

Another less preferred option is to process applications as they are received, using the historic price. In this case, you would need to undertake additional checks and controls to remove the possibility of arbitrage, and to enable prices to be suspended or reworked when necessary.



## Guide to good practice in relation to common issues (cont.)

### Many pieces of information are used to calculate one unit price

You need systems and procedures to check that data has not become unreliable, inaccurate or late. For example, you need procedures to ensure that you obtain timely information, particularly from unlisted trusts, about assets deriving from corporate actions such as share splits and rights issues.

Each data item used in a unit pricing cycle needs to be appropriately checked before it is fed into the unit pricing calculation. The unit pricing team needs training to understand the check for each data item and the importance of undertaking each check.

You need policy and procedures to deal with situations where information is unexpectedly not available – for example, due to computer failure or loss of data feeds.

You should also monitor and report internally on:

- the processes you have in place for obtaining information, and
- the timeliness of the information you receive.

This information will help you to develop more effective systems.

Where you outsource your unit pricing, you must be satisfied that the external service provider is undertaking appropriate checks. For example, you may be able to do this by reviewing reports from the service provider.

### Transaction costs

To the extent that transaction costs are incurred as a result of application and redemption cashflows, people buying and selling units in the fund need to pay an allowance for those costs. The use of a single mid-price with no allowance for transaction costs is not consistent with good practice.

You need to ensure that the transaction cost methodology you use is appropriate for the nature of the fund.



## Guide to good practice in relation to common issues (cont.)

You need to develop comprehensive policy so that:

- transaction costs are calculated and applied consistently and equitably. Any profit from the application of the transaction cost policy must be returned to the fund
- the amount of costs and the method of inclusion are reviewed at appropriate periods. Where transaction costs are estimated, you need to apply a sound and reasonable process. This process should be documented so that you can explain why the estimation process is appropriate
- for the net buyer/seller method, the policy outlines the basis and timeframes to assess the direction of cash flows, to determine whether the buyer or seller price is applied
- transaction costs are not mixed with other costs, such as expenses to acquire research. Other costs need to be disclosed separately as the expenses of operating the fund.

You must periodically review and update your transaction cost methodology and make it available as required.

The transaction cost methodology should not result in money accruing to the product provider. Where there are investment options within a fund, to the extent possible any benefits arising from transaction costs should be retained within each option.

### **Backdating – processing applications other than on the date of receipt**

For each application, redemption or switching 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 that units are issued and redeemed at the price and in the timeframes stated in the governing documents and in the PDS. You must determine timeframes on a reasonable basis, taking account of your obligations. Where, due to unavoidable administrative delays, the actual issue or redemption of units occurs outside such service standards, you need to ensure that the affected unit holders and ongoing unit holders have not suffered loss as a result of your delay. You must consider compliance with your obligations under the law.



### Guide to good practice in relation to common issues (cont.)

We expect that you will make reasonable efforts to ensure that any return derived from unprocessed funds held in an account designated for the purposes of s1017E of the *Corporations Act 2001* is attributed to the investor, subject to any disclosures to the investor: see Corporations Regulation 7.9.08A.

To the extent possible, you should design your procedures and allocate your resources so that delays are avoided and the use of backdating is minimised.

You need to ensure that you have an appropriate number of administrative staff.

Your procedures should cover reprocessing where units have been issued at the wrong price and an adjustment is required.

Despite your best efforts, delays may arise in issuing or redeeming units or processing switches – for example, because:

- a high volume of applications is received on one day
- all the required information is not received at one time and you are not able to process the transactions. This may be the case, for example, for superannuation funds where employers make contributions well before the employee records are received by the fund. This may include a high volume of small contributions
- there are delayed distributions to the fund and the asset value is not known. Where there is a reasonable basis for estimating the distributions, you should undertake an estimation and avoid the need to backdate. However, where there is no reasonable basis for estimating the distributions, it is likely that you will need to take the less preferred option of backdating.

With any delay in processing transactions, 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 you, as the product provider, to fund this difference. Where you are a product provider that has no external source of funds – for example, a not-for-profit superannuation fund without reserves – you need to consider whether ongoing unit holders should fund the difference.



## Guide to good practice in relation to common issues (cont.)

You need to monitor and report internally on the costs of backdating.

### Market disruption

You need policies and procedures to deal with market disruption. In particular you need to plan for:

- suspension and resumption of asset valuations and unit pricing
- suspension and resumption of transactions, and
- notification to unit holders of suspension of unit pricing.

### Manual systems and workarounds

Short-term computer fixes and manual workarounds should be avoided.

In the short term, you need to implement controls and independent reviews to manage these systems. In the longer term, you should replace manual systems and workarounds with automated processes.



### 4.3 Additional unit pricing issues for products with complex structures

You need to take particular care in determining unit prices if the products you provide have additional features that affect the timing or complexity of the unit pricing calculation.

#### Fund of fund structures

You 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. You need to know that the units of the sub-funds are appropriately priced before using those prices as asset values to calculate the unit price of the higher level fund.

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

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

You need to know that the units of the wholesale fund are appropriately priced before using those prices as asset values to calculate the unit price of the retail fund. We have seen instances where fees, distributions, taxes and allowances have been applied without regard for the different rates that apply to retail and wholesale products.

#### Options within a fund

There may be several investment options within one fund. Each option may treat taxes, fees and distributions differently. You need to consider these different treatments when calculating the unit price.

#### Performance fees

Traditionally fees have been paid as management fees, based on 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 have decided 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. Models for performance fee calculations are usually individually designed and often complex. There may be complexity in mechanisms addressing negative performance, in describing benchmarks and in accruing fees between performance measurement points.



### Guide to good practice in relation to products with complex structures

Where you choose to provide more complex products, you must ensure you have the skills, knowledge and other resources to manage those products.

Extra layers of complexity require greater commitment to developing effective systems and procedures. The development and operation of complex systems often benefit from independent review.

#### **Fund of fund structures**

You should build into your unit pricing cycle an allowance for the time needed to obtain unit prices from external product providers. Unit pricing can only move at the pace of the slowest determination of this information.

In limited cases estimates may be required. However, you can adopt this approach only where there is no alternative and only where there is a sound and justifiable basis for making estimates.

When relying on the unit pricing systems of other product providers, you need to take steps, as you would when engaging any other service provider, to ensure that the service meets your requirements – for example, regarding the timeliness of information and the reliability of the approach to unit pricing calculations.



## Guide to good practice in relation to products with complex structures (cont.)

### **Fund of fund structures**

#### **Investments between retail and wholesale funds**

#### **Options within a fund**

You need to design your unit pricing calculations so they can deal with adjustments to taxation, fee, and distribution amounts for sub-funds, wholesale funds or options within a fund. Depending on the nature of your fund, you will need to review at appropriate intervals the documentation of sub-funds, wholesale funds and funds with options to ensure that the correct adjustments are made.

### **Performance fees**

You need to carefully design and test your performance fee model. You also need to review its operation and how it relates to the unit price calculation. Periodically you need to check that the basis of the model continues to be relevant.

Where an accrual can be estimated on a sound basis, this is likely to provide a more equitable outcome. This will depend on factors including the fee model, whether there is a fund of fund structure and the particular circumstances of the fund. Whatever approach you take, you need to develop it on a reasonable basis.

You will need to disclose your approach, including the effect on investors, the frequency of calculating the fee and any limitations on entering and exiting the fund relating to the timing of performance fee calculation. If you issue PDSs or periodic statements, you must disclose fees in accordance with the prescribed fee disclosure template: see Part 7.9, Division 4C and Schedule 10 of the Corporations Regulations 2001.



## 4.4 Managing diversity in systems and products

Some product providers, particularly large product providers with a history of acquisition or extensive product development, are more likely to operate a diverse range of systems and products.

The greater the diversity, the more care you need to take in calculating unit prices.

We have found that the incidence of error is higher where a provider has many products operating under different rules or several administration platforms operating at once.

Diversity may be an issue for you because of:

- the age of your products and their associated documents and systems
- the information technology that you use for unit pricing
- the range of products you provide
- the frequency of your unit pricing.

### Old products and systems

Our unit pricing survey found that life companies and some managed investment scheme operators have a significant proportion of products and systems that are more than 10 years old.

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, such as spreadsheets, that may be undocumented or rely on key staff.

Products that are 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.

If you have old products or systems:

- it may be difficult to integrate these systems with newer technology
- your documentation may be out-of-date and system support may be limited
- system operations may rely on the knowledge of a few key staff
- your systems may lack the flexibility to handle evolving product or control structures
- your systems may be expensive to maintain and upgrade – for example, if programs are written in superseded languages.



### Range of information technology systems

You may use databases with different operating systems, which may make electronic exchange of data difficult. Having diversity in your information technology systems may also hinder the application of standard solutions for development, testing and rectification.

The greater the number of systems you have, the greater the cost of maintaining and modifying those systems.

### Range of product types

Life insurance, superannuation and managed investment scheme products differ in their operating rules, record-keeping requirements and compliance obligations. Products are also affected differently by market and regulatory change, and may require individually tailored system and procedure modifications.

Where you provide different products, maintaining your systems and procedures becomes particularly challenging.

### Frequency of unit pricing

You may provide products that have different unit pricing cycles – for example, daily, weekly and monthly. We have seen misunderstandings about the appropriate values for assets and liabilities (including fees and tax) for each pricing cycle.



### Guide to good practice in managing diversity

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

If you cannot remove complexity, you need to apply additional controls and greater vigilance and undertake regular reviews.

If you have diverse products or systems, you must manage the associated risks. You need to assess the risks of diversity and implement appropriate risk management strategies. For more guidance see section 4.1, 'Effective risk management culture'.

#### Age of products and systems

It may not be feasible for you to replace old products or systems. In this case, additional care and attention are required to manage them effectively as, for example, documentation must be kept up-to-date and the knowledge of key staff must be retained.



## Guide to good practice in managing diversity (cont.)

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

### Information technology

You should plan to simplify and integrate your systems where possible.

Products and systems that are new today may be legacy products or systems in a few years. You need to develop and maintain your systems to keep pace with market and regulatory change, and undertake ongoing review and improvements as required.

You should also ensure that you have appropriate resources available for investment in information technology.

When selecting and contracting with information technology vendors, you should take into account their ongoing ability to upgrade and provide support for your systems.

For more guidance see section 4.5, 'Managing change'.

### Range of product types

You should clearly distinguish price calculation procedures for different product types. You should also conduct reviews periodically to ensure that procedures are updated for regulatory and market change.

### Frequency of unit pricing

You should establish clear procedures for each element of the unit pricing calculation for each separate pricing cycle.



## 4.5 Managing change

Many unit pricing errors arise as a result of change.

Some change occurs in the external environment, while other change is driven by the board and senior management implementing strategic direction. Yet other change comes about during normal business operations.

Regardless of the source, you need to pay particular attention when change occurs – for example, changes in:

- law and regulation
- tax and accounting requirements
- organisational strategy or structure, including takeovers, downsizing or relocation
- staff
- outsourcing arrangements
- product offerings, including investment strategy
- fees or documents, or
- information technology systems.

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

We have found that there is an additional risk of error where there are many changes occurring at one time. In this situation, the internal environment often becomes unstable and management and staff can become distracted. Where many changes occur in combination, the usual checks and reconciliations may not take place or remain adequate. In these circumstances, the risks may not be apparent and unit pricing problems may arise and continue undetected.

### 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. In these situations:

- 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 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 effects of such change
- when companies and their products are acquired, unit pricing problems may be acquired
- 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 the investment accounting, tax, registry, custody or investment management areas.

### Reliance on short-term staff

Some operational unit pricing areas may have long-term reliance on short-term staff. There may be limited opportunities for career progression.

### Change in product offerings

If your product offerings change, you may need to make changes to documents such as scheme constitutions or compliance plans, PDSs, or superannuation trust deeds.

Your unit pricing systems or procedures might not support changes such as:

- investment in pooled funds rather than direct investment in securities, with the associated increased complexity in tax and fee arrangements
- investment in new assets that are difficult to value
- change to fee arrangements, such as the introduction of management or performance fees or fee rebates
- change in benchmarks.

### Change to information technology systems

If your information technology systems change, your system documents may be incomplete and may not provide a reliable basis for system development. System upgrades may not be fully tested or reviewed.



### Guide to good practice in managing change

You should implement simple change management processes to approve, monitor and control change. These processes need to assess the effect of proposed change on unit pricing and need to involve unit pricing staff as early as possible.



## Guide to good practice in managing change (cont.)

The effects of change vary depending on the type of change. Escalation points and measures need to be decided during initial planning. Careful monitoring and detailed reporting are required throughout the change process.

You should provide training to staff and implement a communication strategy so that they understand the extent and effect of the changes. In doing this you should:

- advise staff of implementation timeframes and any reasons for changed timeframes
- consider constructive staff suggestions for managing change, and
- engage staff in the change management process to ensure continuity after it has been completed.

Where possible, schedule the implementation of change to avoid reporting and other peak periods, when business workloads may affect the success of the change program.

Your risk management strategies need to identify and address unit pricing risks and errors arising during change. For more guidance see section 4.1, 'Effective risk management culture'.

### Change in strategy and structure

You need to understand and manage the likely adverse consequences of change in organisational strategy or structure, including lower staff morale and key person risk.

You should also balance the pressure to downsize with the need to provide effective service and comply with your obligations.

Maintaining a strong focus on customer service can help you to direct attention and give priority to the effective operation of your systems, including unit pricing.

When you assess potential acquisitions, you should assess the control environment, including the controls for unit pricing operations.

### Reliance on short-term staff

Where you have high staff turnover, you need effective supervision and training procedures and reliable documentation in place. It may also be appropriate for you to consider ways of reducing your staff turnover.



## Guide to good practice in managing change (cont.)

### Change in outsourcing arrangements

See the guidance in section 4.6, 'Outsourcing unit pricing functions'.

### Change in product offerings

Your product development, change management, risk management, legal, compliance, sales, marketing, tax, accounting, information technology and unit pricing teams need to understand each other's language, timing and processes. If your product offerings change, you need to develop strong communication channels between these areas to ensure that everyone understands the issues and applies a consistent approach.

### Change to information technology systems

You should use appropriate project management methodologies to implement changes to information technology systems. Guidance provided by information technology professional bodies may help.

Operational staff who understand unit pricing procedures need to sign off on 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.

When you test the systems undergoing change, this should not be in isolation from the systems with which they interface. You must also test the downstream effects.

You need to check the old and new systems for consistency – for example, by running them in parallel for an appropriate period, or by independent review.

### Integration risk

Where more than one change is occurring in your organisation, or where you are experiencing frequent change, you need highly effective reporting and coordination to understand and manage the effects of one change on other change, and the effects of change on ongoing operations.



## 4.6 Outsourcing unit pricing functions

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

### Outsourcing for unit pricing

In Australia a number of product providers outsource unit pricing functions to service providers. Our unit pricing survey found that product providers appear to make a decision either to outsource very few, or to outsource the majority of, unit pricing functions.

According to the survey, 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 survey also found that the functions most commonly outsourced are asset valuation and fund accounting. Superannuation providers generally outsource more than life companies and operators of managed investment schemes and, in particular, tend to outsource the calculation of unit prices and tax amounts.

The majority of respondents to our unit pricing survey stated that they had service level agreements (SLAs) in place for most outsourced functions. Some superannuation funds, however, did not have SLAs in place. One-fifth of respondents did not report breaches of SLAs.

In addition, more than a third of outsourcing agreements did not include arrangements for dispute resolution. The survey also found that a quarter of entities did not have arrangements in place to exit outsourcing agreements.

### Effective communication is essential in all phases of outsourcing

The decision to outsource is clearly a determination for the board and senior management. However, we have seen instances where work units have not been consulted about the consequences of outsourcing and the key issues and risks to be managed during the transition to outsourcing. Effective communication channels may not have been set up between work areas, or between work areas and the board.

When assessing possible service providers and later, when setting up a relationship with a particular service provider, product providers may not take the time to clarify the nature and levels of the services required.



Commonly used expressions such as 'soft pricing', 'leverage' and 'performance' can have particular meanings in different organisations. Product providers may not have specified in sufficient detail the nature and frequency of reports to be provided. Subsequently, during the transition to outsourcing, they may not have ensured that reports were considered regularly at senior and operational levels to ensure that any problems were escalated and addressed.



## Guide to good practice in outsourcing unit pricing

### Responsibility for outsourced functions

When you outsource a business activity to a service provider, you are still accountable for the performance of the business activity. The risk of non-performance does not transfer to the service provider: see s601FB and 769B of the *Corporations Act 2001* and s52(2) of the *Superannuation Industry (Supervision) Act 1993*.

You must retain sufficient knowledge of the outsourced functions to effectively:

- monitor both the performance of the service provider and the end-to-end performance of the unit pricing function
- address any deficiencies in performance, and
- ensure continued compliance with all regulatory requirements.

You are also responsible for maintaining up-to-date knowledge of regulatory obligations.

### Outsourcing should be seen as a long-term commitment

You need to carefully choose a service provider. Selecting an inappropriate service provider may lead to business disruption and damage your relationship with your clients or your reputation.

It may take you six to twelve months to effectively transition to outsourced unit pricing functions. You need to work with the service provider to implement the transition using a project management methodology.



## Guide to good practice in outsourcing unit pricing (cont.)

Considerable costs are involved in the 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.

### Develop and implement outsourcing policy and procedures

You need to determine which functions constitute your core business and which functions can be outsourced, and develop a detailed business case.

You should consult the people who are able to assess the risks, costs and 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
- the information technology team
- the legal team
- external asset advisers, and
- other external advisers.

You need to develop criteria to assess the capacity of service providers to meet your requirements and you need to understand the key elements of a service provider's unit pricing methodology, policies, processes and controls. Obtaining up-to-date, accurate and detailed documentation from a service provider – particularly their policies, systems and procedures, including diagrams and process maps – can greatly help in your discussions with them and your review of their compliance standards. You should also undertake reference checks to help you make your decision.



## Guide to good practice in outsourcing unit pricing (cont.)

Assessment criteria may include:

- the financial strength and technical abilities of the service provider
- their ability to understand the objectives of your organisation
- their ability to manage unusual or internationally held assets
- the nature of the relationship management arrangements, including project management during the transition, ongoing relationship management and exit processes
- the systems and staff resources they have available for unit pricing and their capacity to expand. If the number of your investors increases, you may want to increase the number of products and the number of prices, or the frequency of unit pricing
- the nature and frequency of their reports
- the nature of their risk management and compliance procedures, including their internal and external audit and business continuity and disaster recovery procedures
- the profile of their risk management and compliance functions and the resources that are available to them
- the extent of access you and your auditors will have to their records
- how they have managed past problems, and
- their policies – for example, regarding tax and accounting.

### Managing the transition process

The general guidance on managing change in section 4.5 also applies to managing the transition to outsourcing your unit pricing functions.

Communication about outsourcing is in addition to, and should not compromise the effectiveness of, 'business as usual' communications about unit pricing. Discussion and planning for outsourcing usually take place under pressure.



### Guide to good practice in outsourcing unit pricing (cont.)

You must ensure that your staff with the greatest knowledge of critical business functions, including unit pricing, have appropriate support and incentives to work towards the effective transfer of unit pricing functions to the service provider. You need to agree on the project management approach to be taken and develop procedures for decision-making and escalation of issues.

You should also clarify with the service provider:

- the services to be outsourced and the linkages with functions to be retained in-house
- your expectations regarding service provision based on the governing documents of your products. You will need to provide unambiguous, authorised instructions to the service provider based on these documents
- whether functions you retain need to be restructured. For example, some service 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 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. Also, substantial customisation may inhibit subsequent transfer to another service provider. On the other hand, there may be times when standard services need to be brought into step with emerging industry trends, or where there is no choice but to tailor services
- linkages with in-house business continuity and disaster recovery plans. You should test for a range of unusual physical and market conditions and determine the extent of periodic testing and review to be undertaken.

You need to pay attention to the development of strong working relations, both in allocating resources to ongoing management of the relationship with the service provider and in agreeing on the contract for services. One entity or the other may propose their standard form of contract. If the service provider proposes a contract, it is likely that you will need to tailor it to meet your requirements.



## Guide to good practice in outsourcing unit pricing (cont.)

You need to develop SLAs. When drafting SLAs it may be appropriate for you to refer to other documentation, such as procedure manuals and policies.

In negotiating the contract and SLAs with the service provider, you need to consider:

- the nature, frequency and quality of the services to be provided
- standards required for sub-contractors
- whether you write SLAs into the contract, so requiring legal involvement to effect change. As an alternative, SLAs might be set out in a separate document to which the contract makes reference
- procedures for giving authorised instructions to the service provider, and
- timely and effective reporting. Some reports may be provided at pre-determined intervals. Others may be prepared as the need arises, based on pre-determined criteria. Generally, reports from the service provider should include comparisons with performance benchmarks, notification of breaches of SLAs and action taken when breaches arise. To effectively monitor service provider performance, your contract should require timely reporting of SLA breaches.

Your contract needs to:

- provide for resolving disputes with the service provider
- establish mechanisms and assign responsibility for managing unit holder complaints and unit pricing errors
- provide for termination of the outsourcing arrangement and procedures for orderly transition. For example, you need to consider transfer of data and records of fund history
- address the use of confidential information about your clients.

You may need to audit the quality of your data before and after transferring unit pricing functions to the service provider.



## Guide to good practice in outsourcing unit pricing (cont.)

### 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, although some may find a role with the service provider. This affects morale and may affect productivity.

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

### Monitoring 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.

You need to ensure that the service provider provides the agreed reports and that these are reviewed promptly at operational and senior levels of your organisation. You should check that breaches of SLAs are reported to you as soon as possible. The service provider should also refer such breaches to its risk management area as soon as possible.

You need to implement training in your organisation to maintain knowledge of both your regulatory obligations and the outsourced functions. As noted earlier, you remain accountable for compliance with your regulatory obligations.

You should periodically hold discussions with the service provider about issues, including changes to products and compliance with SLAs. Depending on the nature and complexity of your 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. You may need to update SLAs to match shifts in your strategy or the business environment.

If you are a prudentially regulated entity, you need to ensure that APRA can conduct on-site reviews and inspect documents and information held by the service provider.



## Guide to good practice in outsourcing unit pricing (cont.)

### Changing your service provider

When changing your service provider, three parties – the outsourcing entity, the current service provider and the proposed service provider – need to set up effective communication channels. More time is required to communicate effectively. When the number of entities involved increases, the complexity and the risks increase and details may be overlooked. The level of risk increases further where an outsourcing change occurs due to dissatisfaction with current levels of service provision. In addition, if service provision moves from a related to an unrelated entity, you will need to manage any loss of organisational knowledge.

For more information on outsourcing see:

- APRA Superannuation Guidance Note SGN 130.1 *Outsourcing*
- ASIC Regulatory Guide 164 *Licensing: Organisational capacities* [RG 164]
- ASIC Regulatory Guide 130 *Managed investments: Licensing* [RG 130]
- 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 report *Outsourcing in Financial Services*, both published on 2 August 2004.



## Technical issues

Chapter 5 outlines a range of important technical issues in unit pricing and includes guidance on good practice. The good practice guidance is presented as boxed text at the end of each section.

### 5.1 Determining asset values

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

Asset valuation issues include:

- ensuring that valuations are unbiased
- 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. We regard these as prices estimated as a part of normal business operations when actual or hard prices are available, but never in time to strike the unit price. Soft prices are based, for example, on index or other market movements
- determining values where assets are not traded in deep, liquid and well-maintained markets but where there are recognised 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 recognised 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 quarterly. Private equity may also be illiquid
- understanding the age of valuations, including the date of data feeds, and the date of unit pricing by external product providers
- understanding the unit pricing methodology used by external product providers – whether or not fees, fee rebates, transaction costs, tax, or distribution entitlements are included in unit prices
- developing, documenting and implementing valuation policies for the range of assets held in the fund.



## Guide to good practice in determining asset values

### Develop and apply appropriate valuation policies

You need to develop sound and justifiable policies for asset valuation for unit pricing. These policies must be documented, explaining the methodologies, the assumptions, and why they are reasonable and appropriate for the assets.

You need to ensure that valuations are unbiased. As the product provider, you should exercise no undue influence on the determination of asset values.

The nature of your policies will depend on the types of assets in which your products invest.

When developing asset valuation policies, the methodologies need to be consistent with the rules governing the operation of each fund.

Where you outsource some aspects of the unit pricing function, you remain responsible for the valuation policies you adopt.

Your policies need to document delegation levels for approval of valuations.

You need to develop and document procedures to ensure consistent implementation of asset valuation policies. You need to monitor and report internally on the use of these procedures.

You should review and update your asset valuation policies and procedures periodically, and as market conditions change. Obtain expert professional valuation advice where necessary.

You need to provide appropriate resources to support valuation processes.

### Applying estimates

You should not use estimates where actual values are available. However, in some cases, there may be no alternative but to use estimates.

The development and use of estimates should be consistent with your legal obligations, your valuation policies, and the rules that govern the operation of the product. You need to develop estimates on a sound and reasonable basis and be able to justify why an estimate is appropriate in the circumstances.



## Guide to good practice in determining asset values (cont.)

Your estimation policies and procedures need to be developed by people with appropriate expertise. They should be documented, tested periodically using actual data, and updated. For example, you will need to develop an appropriate policy for the timing and amounts to be included in the net asset value for year-end distributions. This may involve the use of estimates in some circumstances.

### Purpose of asset valuation policies

Your valuation policies need to reflect the purpose of valuing the assets, which is determining the entitlements of unit holders, taking into account intergenerational equity for unit buyers and sellers and ongoing unit holders.

This purpose is not necessarily the same as the purpose of valuing assets to prepare financial statements, although in many cases the asset values will be consistent. Accounting standards can provide a recognised benchmark.

However, different values may arise due to differences in timing or valuation methodology. For example, to assist in providing equity, deferred tax may be discounted for unit price calculations. This treatment is not permitted under accounting standards. Such differences should be monitored, analysed and reconciled, at least annually.

You need to make available key information on the valuation bases adopted for assets and related liabilities, and note key differences in reconciling asset values for financial statements and asset values for unit pricing. This should be available in a form accessible to unit holders – for example, in your annual report, periodic statements or on your website.

### Valuation of non-exchange traded assets

There are cases where values are not directly obtained from a market. Instead, values are determined by applying a model, or by periodic third party valuation, or by using an estimate between specific valuation dates. For example, some OTC derivatives may be subject to private valuation arrangements.



## Guide to good practice in determining asset values (cont.)

In all these cases, you are responsible for understanding the valuation bases and ensuring that the bases, including the model and assumptions, are appropriate, objectively reasonable, independently verifiable and internally consistent. The bases must not be subject to your undue influence. You should also ensure that they are periodically reviewed.

You may seek third party professional valuation advice, but you cannot delegate responsibility for determining the asset value.

### 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, and process applications at the price effective on the date of transaction.

Many funds price at least weekly, and large retail funds price daily. However, we note that some superannuation funds may price only monthly or quarterly. If you price weekly or less often, preferably you should batch the applications to buy or sell units, and process them on the day the unit price is struck.

For more guidance see 'Batching' in section 4.2, 'Unit pricing issues common to many products'.

### Frequency of unit pricing and frequency of asset valuation

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

However, the timing of asset valuation depends on the nature of the assets and the valuation process adopted. In some cases, you may need to use reasonable estimates of asset values.

### Soft pricing

You should determine the appropriate frequency for calculating hard prices, and for comparing hard and soft prices, based on the nature of the assets.



## Guide to good practice in determining asset values (cont.)

You should ensure that:

- estimates are checked with sufficient frequency against prices that have been calculated using up-to-date hard prices
- the checking process and explanations of differences are complete, and
- the practice of soft pricing does not encourage the use of inappropriate asset values. For example, values should not be stale (well out-of-date).

You should also determine a reasonable basis for adjusting prices when a significant difference is found. Any rectification action should be documented.

### Assets valued periodically using recognised methodologies

Where there are recognised valuation methodologies, as for property and infrastructure, you should obtain valuations periodically from reputable, professional, third party valuers.

If more than one such asset is held in the portfolio, the periodic valuations should, where possible, occur at different times, to avoid concentrating the effect of any changes in valuation and so causing a price discontinuity. Staggered valuations also assist in early identification of significant market shifts, indicating when it may be prudent to obtain new valuations for other assets.

Between periodic valuations, the value of the asset needs to be considered each time a price is struck. For example, where it is expected, based on experience or the nature of the asset or market movements, that the value of an asset is likely to increase at the next valuation, and there is a recognised methodology for doing so, 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 discontinuity. Those who sell immediately before the price discontinuity will be disadvantaged, while those who buy immediately before the price discontinuity will be advantaged.

Price discontinuities cannot be avoided entirely. Once a value has been determined, you should include it in the unit price.



## Guide to good practice in determining asset values (cont.)

However, to promote equity between unit holders, you should take steps to minimise the effect of price discontinuities.

### Other illiquid assets

Certain hedge fund assets might only be valued every three months. Private equity might also be difficult to value frequently.

Where an asset is valued infrequently, daily or weekly prices cannot be struck between valuations unless there is a reasonable basis for estimating the unit price.

Using estimates may be acceptable where illiquid assets comprise a small part of a large portfolio. You need to determine what is an acceptable proportion of assets in the circumstances of your product. You also need to determine a reasonable basis for making any estimation of value, having regard to your obligations, including the obligation to treat members equitably. Using estimates would not be appropriate where illiquid assets comprise a significant part of a portfolio.

### Thinly traded assets

Some assets may be traded on deep, liquid and well-maintained markets, but may not have traded for long periods. You need to consider whether 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.

### Effect of the hold-sell strategy on the valuation model

You should not use long-term valuation models where assets are to be sold in the short-term. For example:

- the period of time for which it is assumed an asset will be held in net present value methodology needs to be determined by reference to the hold-sell investment strategy of the fund
- assets are usually valued on a 'going concern' basis. However, this is clearly unsuitable where a scheme is being wound up and the assets are to be sold quickly.



## Guide to good practice in determining asset values (cont.)

### Foreign assets

You need to carefully determine and consistently apply policy that sets the time at which you take the value of foreign assets or the time at which you strike the associated exchange rates.

For assets denominated in a foreign currency, the appropriate exchange rate may be identified in the fund documentation. Otherwise, you need to develop a policy to determine the exchange rate appropriate for the valuation point. For example, the exchange rate may be the Reuters 4pm London Exchange Rate or the last exchange rate at which a transaction in that currency took place, if more appropriate.

### Transaction costs should not be included in asset values

Our general guidance is that a separate allowance for transaction costs should be included in the calculation of the unit price. Asset valuations should not normally include allowances for the costs of buying or selling those assets. In circumstances where transaction costs are unavoidably included in the cost of an asset, you need to ensure that transaction costs are not counted twice.

For more guidance see 'Transaction costs' in section 4.2, 'Unit pricing issues common to many products'.



## 5.2 Determining tax treatments

This section is relevant if you are an entity that is directly responsible for paying tax where this tax is included in the unit price of your products. In this case, you prepare tax calculations and tax returns and related accounting records for the unit priced fund.

Determining 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.

Tax issues relating to other unit trusts, including registered managed investment schemes, and their distributions are not discussed in this guide.

### Administration of tax

The administration of tax requires substantial attention to detail. We have seen errors arise, where, for example:

- the resources provided for it have been inadequate
- tax policies have not been reviewed
- there has been change in investment structure, or
- there has been staff turnover.

Particular care may be required in determining tax treatments where a pooled superannuation trust operates products in both an accumulation and a pension phase and does not segregate the assets.

### 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.

We have seen issues relating to the time when the fund manager or life insurer recognises imputation credits for the calculation of the unit price. For example, we have found that 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 also leads to a change in the treatment of the associated imputation credits.

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



### **Treatment of deferred tax assets (future income tax benefits – FITBs)**

Funds may have actual or net unrealised tax losses that can be carried forward as deferred tax assets or future income tax benefits (FITBs). These FITBs are available to offset future capital gains tax liabilities or future unrealised gains. FITBs may also be written off – for example, if market movements mean they are unlikely to be realised. Issues arise relating to the amount of FITBs that can be recognised, and the circumstances in which FITBs can be recognised.

Our unit pricing survey showed a range of practice in recognising FITBs. Our review also found that where a view has been formed that the deferred tax benefits have been overstated, FITBs may not have been reduced to an appropriate level.

### **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 generally taxable at 15%. Where it is sold more than 12 months after acquisition, the gain is generally taxed at 10%. For some assets that have been held for a long time, the prior basis, allowing for CPI indexation, may apply instead. Issues arise relating to the treatment of unrealised capital gains and losses, based on assumptions about future asset turnover.

There have been instances where the amount of tax payable on the gain has been over – or underestimated in the unit price calculation.

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

For both current and deferred tax allowances included in unit prices, reconciliations followed by investigation of differences – against periodic accounts, financial statements and tax returns – may help to prevent or identify unit pricing problems.

Our unit pricing survey showed a range of practice. Most respondents reconciled tax frequently – for example, 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.



Issues arise relating to the timing of reconciliations and the treatment of any differences. Our review of unit pricing practice found that reconciliations may not be undertaken or differences investigated. We also found that tax refunds may not be promptly obtained or included in the reconciliation calculations.

Our 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.



### Guide to good practice in determining tax treatments

We expect that you will obtain expert advice on tax issues as required and apply that advice to obtain equitable outcomes for unit holders.

A reasonable estimate of the tax provision must be used each time a unit price is struck. This estimate must be reconciled with the tax provisions in the accounts from time to time.

#### Administration of tax

You need to develop sound, justifiable and robust policies for tax treatments for the range of foreseeable circumstances. These policies must be documented, explaining the methodologies, the assumptions, and why they are reasonable and appropriate for the fund.

You need to develop procedures to ensure consistent implementation of tax policies, including circumstances where the policies require the exercise of judgement. You need to monitor and report internally on the use of these policies and procedures.

You should periodically review your policies and procedures and ensure that you are satisfied that your policies comply with relevant legislation, seek to achieve equity between investors, and are otherwise determined on a reasonable basis. Obtain expert professional advice where necessary.

You need to provide appropriate resources for the unit pricing tax function.

For more guidance see section 4.1, 'Effective risk management culture' and section 4.5, 'Managing change'.



## Guide to good practice in determining tax treatments (cont.)

### Estimation and assumptions

While tax treatments 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.

The use of an effective or estimated tax rate or rates in day-to-day unit pricing calculations may be appropriate where:

- there is frequent reconciliation, and adjustment mechanisms are in place
- the method allows for differences in taxable income that may arise from differences in asset types (that is, the rates incorporate estimates that reflect different tax treatments for different components of the return)
- the rates treat different unit holders equitably.

Where assumptions are used for tax treatments in unit pricing, those assumptions need to be checked periodically by internal or external tax specialists.

### Treatment of imputation credits

The principle is that unit holders present in a product at the time an amount accrues should receive the benefit of that amount in the unit price, even if legal entitlement arises later. This principle should be reflected in the policy for imputation credits to the extent possible.

For entities responsible for paying tax in unit priced products, 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 from a trust to include imputation credits. Where there is a periodic (for example, quarterly) distribution and the trust provides information on imputation credits, they should be included at that time. If not, a soundly based procedure to progressively estimate imputation credits during the year is preferred.



## Guide to good practice in determining tax treatments (cont.)

When determining an estimate, factors you should consider include, but are not limited to:

- prior year experience – franking credit history and dividend history
- the nature of the fund
- market trends, and
- the stability of your product's holding in the investment.

You need to address imputation credits 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, or when the information is available, or when an estimate can reasonably be made. 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 that you do not control, other than a pooled superannuation trust, and the trust invests in shares, your method for including imputation credits in the unit price will vary depending on the frequency of distributions by the trust and the availability of the related tax information, as set out above.

When you select such investments, you also need to consider the timeliness of information provided by product providers.

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 estimate basis, or on the basis of periodic (for example, quarterly) information. This will minimise the likelihood of a sizeable price discontinuity which could arise if the imputation credits were recognised once a year.

We recognise that imputation credits should not be included in the unit price if the right to the credits is forfeited – for example, under the '45 day' rule.



## Guide to good practice in determining tax treatments (cont.)

Foreign tax credits, on the other hand, often 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. However, if you can include the effect more frequently because you have received the dividends, or information on the credits more frequently, then you should do so.

### Treatment of deferred tax assets (future income tax benefits – FITBs)

FITBs should be included in unit prices to the extent that they have value for present or future unit holders, taking into account the circumstances of the fund, the governing documentation, possible events, the likelihood and timing of those events, and your approach to discounting to allow for the time value of money. The value of FITBs included in unit prices should be systematically reviewed to help achieve equity between investors and to minimise price discontinuities in unit prices.

We would not expect to see a tax policy that always, or never, recognises FITBs. It is reasonable to consider capping the amount of FITBs included in unit prices.

For these and other reasons, the amount of FITBs included in unit prices may not match the amount of FITBs reported in financial statements. Depending on the size or the reasons for the difference, differences may need to be explained in the financial statements.

When determining the amount of FITBs in unit prices and any cap on FITBs, factors you should consider may include, but are not limited to:

- the level of unrealised gains/losses
- expectations of market movements and their likely volatility
- the investment timeframe
- likely investment inflows and outflows for the fund



## Guide to good practice in determining tax treatments (cont.)

- the extent to which FITBs in one pool can be applied against gains elsewhere in the same entity or consolidated entity
- the applicable tax rate
- exposure of the fund to possible significant redemptions, and
- marked change in the circumstances of your product.

### Treatment of capital gains

Assessing deferred tax on unrealised gains and losses can be complicated because:

- 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, and
- the assets are likely to have been held for various periods of time.

The treatment will depend on the length of time the asset is held. Where an asset has been held for less than a year, in many cases deferred tax will be calculated on the full capital gain rate of 15%. In some cases, however, there may be a sound basis for adopting a different approach where the asset is expected to be held for more than a year. Where an asset has been held for more than a year, deferred tax will, in most cases, be calculated on the reduced capital gain rate of 10%, unless the old CPI basis applies.

It may also be appropriate to make an allowance for the time value of money, depending on your approach to discounting. For more guidance see 'Purpose of asset valuation policies' in section 5.1, 'Determining asset values'.

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

You should prepare reconciliations that compare the amounts used in unit pricing with the amounts, separately calculated, which are reported in financial statements and annual tax returns.



## Guide to good practice in determining tax treatments (cont.)

You should prepare at least the following three types of reconciliation to:

1. compare and resolve differences between the allowance for current tax in the unit price with the corresponding provisions in the accounts. Also compare and resolve differences between the allowance for current tax in the unit price with tax returns and with full year 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, and
3. compare and resolve differences between the movement in current tax and the movement in deferred tax.

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.

When determining the frequency of reconciliations, other factors to be considered include:

- whether you use estimates of tax rates – if so, more frequent reconciliations are required, and
- the types of asset held as investments.

Preparing reconciliations more frequently increases the likelihood of identifying problems early, and thus minimises the likelihood of accumulating errors in the unit price.

### Treatment of differences identified during reconciliation or apportionment

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



## Guide to good practice in determining tax treatments (cont.)

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 to share losses and gains and to equitably compensate pools. Your compensation policy should consider the rate and the order in which losses are offset.

We would normally expect any identified differences (positive or negative) to be applied to unit holders – including where the differences result from the combination of, or other interactions between, different classes of unit holder. This practice needs to be applied consistently and disclosed. If an alternative is adopted, this needs to be well considered, documented and justified.

Crediting differences to a reserve is acceptable where the reserve complies with our guidance in section 5.3, 'Determining the use of reserves'.

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

In considering whether compensation is required when you make an adjustment to a unit price, it is essential to consider whether the unit price being adjusted was developed in accordance with soundly based and appropriate tax policies that were applied consistently.

For example, where estimates included in a unit price need adjustment as the actual amounts become known, or where a reasonable tax policy is nonetheless reviewed from time to time and updated, neither the unit price before the change nor the unit price after the change is incorrect for the purpose of deciding whether compensation is required.

Where such a change is to be made to a unit price, 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 tax policy has been, or is, inappropriate or where the application of tax policy has been, or is, deficient.



### 5.3 Determining the use of reserves

A reserve is an amount that is not presently allocated to members. It is an excess of assets over unit holder entitlements and fund liabilities. A reserve is an amount held separately to deal with various contingencies arising during the operation of the fund.

A reserve is not the same as a provision, which is an amount set aside to meet specific obligations of the fund, such as provisions for fee and tax payments. The guidance in this section does not relate to such provisions.

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

Reserves should not be transferred to the product provider. Reserves belong to members and are recorded in the equity section of a fund's balance sheet. Although members do not have a present entitlement to amounts recorded as reserves (including retained profits), these amounts remain attributable to unit holders if the reserve is no longer required or if a product is wound up. This is not the case with the accrual of management fees in a provision, where the accrued fees are attributable to the product provider.

#### Using reserves

Some product providers – for example, not-for-profit superannuation funds – may use reserves, which may include amounts for:

- future capital expenditure
- unforeseen operational losses, as a form of operational risk capital
- monies not yet allocated to members
- differences between valuation for accounting purposes and valuation for unit pricing purposes – the resulting reserve enables the statement of financial position to balance.

You need to consider whether the use of your reserves is consistent with your obligations to unit holders. You also need to determine how you will disclose reserves to unit holders – for example, in the accounts or in a disclosure document – to comply with your obligations.

We have found that some product providers do not:

- conduct sufficient periodic review of their basis for transferring amounts from unit holder funds into reserves. Reserves may become larger than required and the subsequent rectification and reallocation to unit holders can be complex



- clearly define the purpose of their reserves, or
- implement procedures to ensure that reserves are used only for the intended purpose.

### **Reserves and crediting rates**

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 crediting rates in years of poor return. This may be perceived as affecting 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.

### **Not-for-profit superannuation funds and other mutually owned entities**

We have also found that reserves have been used in other ways, particularly by not-for-profit superannuation funds and other mutually owned entities, which may have no source of funds other than money received from members in the normal operation of the fund.

### **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. Smoothing reserves should not be used with unit pricing for this purpose.

We also note that a fund operating a smoothing reserve may not constitute a unitised fund for the purposes of the member protection standards under reg 5.14 of the Superannuation Industry (Supervision) Regulations 1994.



## Guide to good practice in determining the use of reserves

You should only use reserves for an agreed purpose that has a reasonable basis. When reviewing the purpose and operation of reserves, we will consider ‘substance over form’ rather than considering the naming system used in the accounts.

You need to develop sound and justifiable policies for the use of reserves, including the principles that determine who has authority to decide:

- when reserves are established or changed
- the amounts held
- when amounts are to be transferred into the reserve, and
- when amounts can be used.

These policies must be documented, explaining the assumptions and why they are reasonable and appropriate.

You need to develop procedures to implement these policies, and monitor and report internally on the use of these procedures.

On a regular basis you need to consider whether:

- the original purpose of the reserve is still relevant for the operation of the fund
- amounts held in reserves are appropriate for the stated purpose, and
- reserving policies and procedures continue to be relevant.

Any excess over the appropriate amount should be allocated to the unit holders at the time of your review.

The purpose of reserves, and policies governing the operation of reserves, should be clearly stated in a form accessible to unit holders, together with information about amounts held in reserves. You need to decide the most appropriate way to provide this information, depending on factors including, but not limited to, the nature of the product, the size and impact of reserves and the characteristics of unit holders. For example, it may be appropriate for you to provide information in financial statements, on a website, or on request.



### Guide to good practice in determining the use of reserves (cont.)

Where a reasonable policy framework has been consistently applied within a well-controlled environment, the fact that a reserve is later found to be greater than expected would not constitute an error.

Under s52(2)(g) of the *Superannuation Industry (Supervision) Act 1993*, any reserves must be prudentially managed in a manner consistent with the fund's investment strategy and its capacity to discharge its liabilities as and when they fall due. Following the guidance in this section will help you comply with this obligation.

#### **Do not use smoothing reserves with unit prices**

While it may be appropriate to use smoothing reserves with crediting rates, you should not use smoothing reserves with unit pricing.

#### **Commencement of unitisation**

If you are considering a change from a crediting rate system to unit pricing and you have reserves in place, you need to re-evaluate the need for any ongoing use of reserves before moving to unit pricing. In general, you should distribute smoothing or investment fluctuation reserves to members before the transition to unit pricing.



## 5.4 Applying accounting standards

Product providers that are 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

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, and
- 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*.

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, these entities 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 the basis for calculating the unit price, if possible, so that the bid price is used for both financial reporting and unit pricing. Again, there may be consequent increased costs.



Product providers have noted that, in some cases, the constituent documents of unit priced funds specify detailed methods of calculating 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. This issue has been addressed in some cases – for example, in ASIC Class Order [CO 04/1575]: see below. However, there are different considerations for life policies.

In some cases, product providers 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.

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

### **AASB 132**

*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 (among other conditions). Because a unit pricing product provider has a contractual obligation to deliver cash to unit holders when units are redeemed, unit holder entitlements will now be recorded as liabilities rather than equity in financial statements.

Some product providers have stated that confusion may arise where unit holders are accustomed to referring to the equity section of the financial statements (assets minus liabilities) to determine total unit holder entitlements.

Some product providers 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.

We note that, for many years, life companies have recorded unit holder entitlements as liabilities, because payments based on insurance contracts are liabilities.



### **Class Order [CO 04/1575]**

ASIC Class Order [CO 04/1575] *Managed investment schemes: unit pricing* allows responsible entities of registered managed investment schemes to make amendments to scheme constitutions without a special resolution of members. Amendments can be made so that references to accounting standards in constitutions are to accounting standards in force immediately prior to 1 January 2005 and are not affected by the transition for financial reporting purposes to Australian equivalents of IFRS. Any such amendments must substantially preserve the rights of members as they were before the amendment.



### **Guide to good practice in applying accounting standards**

#### **Compliance with Australian equivalents of IFRS**

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

Accordingly, as a reporting entity you must ensure that you comply – for example, by:

- reviewing your agreements with unit holders, including governing documents, and reviewing disclosure documents and managed investment scheme compliance plans, to ensure that the impact of the new accounting standards on the operation of the fund is understood
- implementing change to documents, where necessary
- implementing change in unit pricing practice, where necessary
- modifying computer systems and unit pricing and accounting record-keeping procedures, where necessary, and
- determining what new disclosures, if any, are required and establishing systems and procedures to ensure that those disclosures are made.

For more guidance see section 4.5, 'Managing change'.



 **Guide to good practice in applying accounting standards (cont.)**

**Disclosures to unit holders**

Where there is potential for confusion about unit holder entitlements – for example, where entitlements are reclassified from equity to liabilities – you need to clearly explain the change to unit holders and tell them where they can find information about unit holder entitlements.

Where financial statements show negative equity, you need to ensure that you make appropriate disclosures 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.

In the financial statements, you need to provide a summary of your practice regarding the matters discussed in this section (section 5.4). Use reconciliations, if appropriate, to explain the consequences for unit holders of the approach you have used.

For more guidance see 'Purpose of asset valuation policy' in section 5.1, 'Determining asset values'.



## Consumer issues

Chapter 6 outlines a range of important consumer issues in unit pricing and includes guidance on good practice. The good practice guidance is presented as boxed text at the end of each section.

### 6.1 Providing information about unit pricing

You are subject to a range of obligations to provide information. For example, there are specific obligations to provide PDSs and periodic statements to unit holders.

In addition, you may provide information to unit holders to meet other obligations, or voluntarily.

In other cases you must provide information directly to regulators – for example, to notify ASIC of non-compliance with AFS licensee obligations.

We have seen cases where statements about unit pricing have not been consistent in all the documents that relate to any unit priced product. For example, the statements in a scheme constitution have not been consistent with the statements in the related PDS. Unit pricing errors may arise where documents are not consistent.

We have also seen cases where statements in documents have not matched practice. For example, a change in calculation method or asset valuation methodology or a change in treatment of fees has not been supported by the statements in the related life policy or PDS.

Some of the ways in which information may be provided to unit holders are set out below.

#### **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 managed investment scheme constitution must make provision for a unit price that is independently verifiable: see s601GA of the *Corporations Act 2001* and ASIC Regulatory Guide 134 *Managed investments: Constitutions* [RG 134].



## Documents setting out compliance obligations

Compliance plans of registered managed investment schemes and risk management plans of registered superannuation entities discuss procedures for calculating and reviewing unit prices and valuing assets: see s601HA of the *Corporations Act 2001* and s29P of the *Superannuation Industry (Supervision) Act 1993*.

### PDSs

Your PDS is directed to people who are deciding whether to acquire units in a product, and discusses matters including the benefits, risks and costs associated with investing in the product: see s1013D, 1013E, 1013F of the *Corporations Act 2001*.

ASIC Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* [RG 168] notes 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’: [RG 168.20].

A supplementary PDS 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.

See s1014A of the *Corporations Act 2001* for more information.

### Information to be considered for disclosure

Taking into account your legal obligations and the nature of your products, you may decide to provide information in the PDS and/or in some other accessible document or form.

For example, 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 **whether** it is appropriate to provide the following information **and the form** in which the information will be provided:

- 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, particularly for products with complex structures
- details of other fees relating to the acquisition and disposal of units
- how the unit price is calculated and the frequency of calculation
- the method of calculating the costs of acquiring or disposing of underlying investments, and the effect of these transaction costs on unit price, as people acquire or dispose of units
- the types of costs, such as brokerage, that are included in transaction costs
- whether the price may be changed or transactions suspended where historic pricing is used
- other circumstances in which unit pricing might be suspended
- the purpose of, and the procedures relating to any reserves.

For more information see ASIC Regulatory Guide 182 *Dollar disclosure* [RG 182], ASIC Information Release [IR 05–19] *ASIC provides answers on some fees and costs questions* and the fee disclosure template prescribed in Schedule 10 of the Corporations Regulations 2001.

### Transaction confirmations

Where a person acquires or disposes of a unitised product, generally you must confirm the details of the transaction including the date and description of the transaction and the amount paid: see s1017F of the *Corporations Act 2001*.

### Ongoing disclosure to unit holders about changes and events

You must 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: see s1017B of the *Corporations Act 2001* and see also the modifications to s1017B in relation to superannuation products set out in Part 10 of Schedule 10A of the Corporations Regulations 2001.

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: see s1017B(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 additional information: see s1017C of the *Corporations Act 2001*.

## Periodic statements

Each year you must give information to unit holders of managed investment, superannuation and investment life insurance products: see s1017D of the *Corporations Act 2001*. This information is generally in the form of a periodic statement and includes:

- opening and closing balances for the period
- details of transactions during the period
- return on investment during the period, and
- details of any change in circumstance affecting the investment that has not been notified since the previous periodic statement.

## 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: see s314 of the *Corporations Act 2001*. If a fixed dollar minimum is applied to compensation amounts in respect of a unit pricing error for exited unit holders, this information must be included in the annual financial report for the relevant fund.

## Websites

Where there is no specific obligation on you to provide information, but you decide it is consistent with your broader obligations to do so, we expect that you will make this information available in an appropriate form. Depending on the circumstances, you may use channels such as websites, call centres or correspondence, or include information in documents provided under statutory obligations.

For example, you may include the PDS and current prices for unitised products on your website.

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. If a fixed dollar minimum is applied to compensation amounts in respect of a unit pricing error for exited unit holders, this information must be made available on your website.



## Correspondence with unit holders

If a problem has arisen, you 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. If a fixed dollar minimum is applied to compensation amounts in respect of a unit pricing error for exited unit holders, this information must be made available on your website.

## 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, you may provide call centre staff with scripts to explain what has happened and how the problem is being rectified.

## Breach notifications

You must notify ASIC of significant breaches of AFS licensee obligations: see s912D of the *Corporations Act 2001*. Depending on the circumstances this may include notification of problems in unit pricing.

For more guidance see 'Communicating with the regulators about errors' in section 6.3, 'Managing errors and compensation'. You should also refer to the ASIC guide *Breach reporting by AFS licensees* (October 2004).



## Guide to good practice in providing information about unit pricing

### Develop and apply appropriate policy

You need to develop sound and justifiable policies for providing information. Your policies must comply with relevant legislation. Your policies need to be documented, and need to explain why they are reasonable and appropriate.

You need to develop procedures to ensure consistent implementation of your policies. For example:

- you retain responsibility for compliance with obligations. However, it may assist if, in large corporate groups where one service provision area (for example, marketing or legal) provides services to many unit pricing entities in the group, individuals in that service provision area are nominated to assist each unit pricing entity to meet information provision obligations



### Guide to good practice in providing information about unit pricing (cont.)

- you need to establish communication channels between work areas including unit pricing, tax, accounting, product development, marketing, risk management and legal and you need to establish periodic independent internal or external reviews to:
  - ensure ongoing consistency of documents and unit pricing practice
  - ensure that all work areas have the same understanding of timing to implement change.

Where there are changed circumstances, to the extent possible you should:

- provide complete information 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
- check disclosures for clarity and completeness. Information should be provided in a coherent and accessible form, not in a fragmentary or obscure manner. For complex issues, working with marketing or other communications experts, or consumer testing may help you develop clarity in the information you provide to unit holders
- provide information as soon as possible to prospective, current or past unit holders, advisers or employer sponsors of superannuation schemes. Where possible, provide information before a change takes place to assist unit holders and potential unit holders to make appropriate decisions. Failure to disclose appropriate information in a timely way may be a breach of financial services laws
- update all relevant documents to reflect the change and co-ordinate updating of documents to match the timing of the change.

You need to monitor and report internally on the use of your procedures.



### **Guide to good practice in providing information about unit pricing (cont.)**

You should also periodically review your policy and procedures and obtain expert professional advice where necessary.

For more guidance see section 4.1, 'Effective risk management culture', section 4.5, 'Managing change' and section 6.3, 'Managing errors and compensation'.

#### **Apply Good Disclosure Principles**

You need to consider the Good Disclosure Principles for PDS disclosure described in [RG 168]. These principles are:

1. Disclosure should be timely
2. Disclosure should be relevant and complete
3. Disclosure should promote product understanding
4. Disclosure should promote comparison
5. Disclosure should highlight important information
6. Disclosure should have regard to consumer needs.



## 6.2 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: see ASIC Regulatory Guide RG 165 *Licensing: Internal and external dispute resolution* [RG 165] for more information.

If you're an AFS licensee, you must provide dispute resolution systems for retail clients: see s912A of the *Corporations Act 2001*. These obligations also apply where you provide a financial product to retail clients and you do not hold an AFS licence: see s1017G of the *Corporations Act 2001*.

You must comply with additional complaints management obligations if you are:

- the responsible entity of a registered managed investment scheme: see s601GA of the *Corporations Act 2001* and ASIC Regulatory Guide 134 *Managed investments: Constitutions* [RG 134]
- the trustee of a superannuation fund (other than self managed superannuation funds): see s101 of the *Superannuation Industry (Supervision) Act 1993*.

The Financial Services Guide provided to retail clients by an AFS licensee or by the licensee's representative, and the PDS must provide information about the dispute resolution system that covers complaints by clients to whom the financial service is provided, as well as information about how that system can be accessed: see s941A, 941B, 942B, 942C and 1013D(1)(g) of the *Corporations Act 2001*.

External dispute resolution systems, including the Financial Ombudsman Service (FOS) and the Superannuation Complaints Tribunal (SCT), are not required to deal with all types of complaint: see [RG 165].

Depending on the nature of the issue, concerns about unit pricing may be outside the jurisdiction of FOS and the SCT. Such complaints may be 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.

Nevertheless, you need to address any unit holder concerns or complaints about unit pricing through your internal dispute resolution system.

Effective complaints handling should, among other outcomes, increase levels of consumer satisfaction, and help to improve the quality of your products and services: see Australian Standard AS 4269–1995 *Complaints handling*.



Our review found that:

- 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. You may need to analyse certain types of complaint for unit pricing impact in addition to considering the specific issues raised by the unit holder
- a cursory approach to complaints classification will not help you identify hidden trends
- receipt of complaints may be uncoordinated. 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 a telephone conversation with a call centre operator.



### Guide to good practice in managing complaints

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

You need to consider management of complaints and other customer feedback as an essential part of risk management. Analysing customer complaints can help identify systemic problems and emerging trends.

You should ensure that:

- resources are made available to manage complaints effectively and consistently
- employees are encouraged to report instances of customer dissatisfaction, and
- **all** customer feedback is taken seriously and a summary of trends and key issues from all parts of the organisation is reported to senior management.

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



## Guide to good practice in managing complaints (cont.)

For more guidance see section 4.1, 'Effective risk management culture'.

[RG 165] provides that you should document your internal dispute resolution procedures to make them as transparent and accessible as possible and to assist with staff training and awareness. This includes:

(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 issues

(b) the types of remedies available for resolving complaints

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

You should provide a copy of your complaints handling 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.

[RG 165] provides guidance on the application of AS 4269-1995 to internal dispute resolution procedures in the financial services industry. You should refer to both [RG 165] and AS 4269-1995.



## 6.3 Managing errors and compensation

This section should be read in conjunction with good practice principles 2.3 and 2.4 in Chapter 2.

### Errors

If there are errors in unit pricing, unit holders do not receive the share of the value of the fund to which they are entitled. As noted throughout this guide, errors may arise from various sources.

There may be errors in the number of units allocated. There may also be errors in the price per unit, 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 fewer units are issued on entry to the fund. If there is no correction to the number of units, the unit holder will hold a lower value in the fund than should have been received
- the unit price to be too low at the time of withdrawal then, when a unit holder withdraws from the fund, the total amount paid to the unit holder for units redeemed is less per unit than the unit holder's actual entitlement to fund value.

#### 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 ongoing unit holders
- 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 ongoing unit holders.

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 price of units – flows through all subsequent transactions, in addition to the effect of repeating the initial error in subsequent transactions, until the error is identified and stopped. Errors may affect many thousands of transactions.



Where unit holders have gained an advantage due to a unit pricing error, you may choose to bear the cost, or you may seek to recover the amount from those unit holders. It may not be feasible or legally possible 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. Depending on the circumstances, including whether members are ongoing or exited, and whether performance has been positive or negative, appropriate compensation will include an amount for:

- investment performance (the investment rate of return is applied to the amount invested for the relevant period), or
- the time value of money (a rate such as the RBA cash rate is applied to the amount for the period of the error).

For ongoing unit holders, compensation may be paid by issuing more units or by adjusting the price of units. For unit holders who have left the fund, compensation is often paid by cheque.

In addition, unit holders in a registered managed investment scheme may take action against the responsible entity under s601MA of the *Corporations Act 2001* for any loss, while unit holders in superannuation funds may take action for loss under s55 of the *Superannuation Industry (Supervision) Act 1993*. For more information see section 6.2, 'Managing complaints'.

### 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 your business
- damage to your reputation
- the costs of calculating the amounts of compensation payable and the payment of those amounts
- the costs of system and procedure rectification, and
- amounts paid for any external review or advice.

Identifying a source of funds to pay these costs and to pay compensation is a particular issue where you are a not-for-profit superannuation fund, without substantial capital reserves. In such a case, you may look to insurance or to a service provider that caused the error, or you may be able to draw on a compensation reserve built up over time from within the fund.



You may need to involve the ATO when considering errors and compensation. There may be consequential impacts on unit holders – for example, regarding overpaid tax or compensation for tax. These impacts need to be factored into your approach to determining compensation.

Issues may arise where compensation is to be paid to a unit holder who has already commenced an income stream product. Other issues may arise where compensation is being paid within the superannuation system. It may be appropriate to discuss these issues with regulators.



## Guide to good practice in managing errors and compensation

### Manage unit pricing errors effectively

Regardless of the quality of your systems and controls, errors may occur. You need to establish policies and procedures for managing unit pricing errors and addressing compensation issues.

You should have these policies and procedures in place so that, in the event of an error being identified, you can give priority to limiting damage, addressing the loss to unit holders and preventing recurrence of the error. In our review we found cases where an error was identified but the product provider was instead focused on establishing processes to deal with the error.

Your policies and procedures for managing unit pricing errors and compensation should include steps to:

- limit the consequences as far as possible and monitor new applications and redemptions while you identify the extent of the problem;
- 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;
- compensate unit holders – the individuals or the fund – if compensation is appropriate. This includes making reasonable efforts to contact former unit holders; and
- communicate appropriately with unit holders. Our review found instances where complete information wasn't provided to unit holders about the steps and timing to fix an error, including an



### **Guide to good practice in managing errors and compensation (cont.)**

explanation of how any compensation would be paid. You need to clearly and plainly tell them what went wrong and why, as well as how the problem will be fixed and when. This includes:

- communicating with individual unit holders affected by the error, and advisers if appropriate; and
- making reasonable efforts to contact affected former unit holders.

Depending on the nature of the error, you may wish to communicate with all unit holders, whether or not affected.

- provide information as soon as possible after an error has been discovered. It is necessary to strike a balance between providing information quickly and providing information that is sufficiently complete so as to be meaningful to unit holders. You should move promptly to ascertain the nature and scale of the problem so you can notify affected people – the shorter the delay, the better;
- determine the appropriate timing and frequency of communications, consistent with your obligations. Factors you need to consider may include, but would not be limited to, the size of the error in total and the size of the error for each affected person;
- where a correction is required, appropriately manage the possibility of arbitrage, to the extent that there is the possibility that people can time their buying or selling to take advantage of a change in unit price or a change in the number of units;
- 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; and
- properly consider who pays recovery costs. Unit holders do not usually bear the costs of compensation.



## Guide to good practice in managing errors and compensation (cont.)

Independent review by external experts is likely to be important in quantifying errors and rectifying your systems. Thorough review may help you to avoid future errors.

For more guidance see section 4.1, 'Effective risk management culture'.

### Communicating with the regulators about errors

You need to communicate with us as soon as possible when a unit pricing error has been detected.

For AFS licensees, unit pricing errors may be significant breaches requiring notification under s912D of the *Corporations Act 2001*. For responsible entities of registered managed investment schemes, unit pricing errors may involve a breach requiring reporting under s601FC(1)(l) of the *Corporations Act 2001*. For superannuation trustees, unit pricing errors may be breaches requiring notification under s29JA(1) of the *Superannuation Industry (Supervision) Act 1993*.

You need to notify us of a unit pricing error as soon as possible. You should then move as quickly as possible to provide full advice to us about the error and your proposed course of action. We acknowledge that you may not be able to provide all of this information when you initially notify us of the error. The information we will seek from you will include:

- the name, type and size of product(s) affected by the error;
- the timeframe and project management approach for investigation, if required;
- any proposals for external review;
- the nature, size and cause of the unit pricing error;
- the period(s) over which the error occurred;
- whether you have notified other regulators – for example, the ATO where tax is an issue;
- the numbers of unit holders and former unit holders affected by the error including those exited unit holders where



## Guide to good practice in managing errors and compensation (cont.)

compensation, if paid, would be below the fixed dollar minimum applying in accordance with the following section;

- your basis for determining whether compensation is payable including the basis for determining any fixed dollar minimum to be applied to compensation amounts to exited unit holders in accordance with the following section;
- your basis for deciding the amounts of compensation to be paid and who will receive it:
  - you need to have a policy that takes account of all legal obligations relevant to your circumstances
  - you need to apply this policy, to determine compensation payable, in a way that is consistent with your obligations
  - you should not profit from any error
  - you need to demonstrate to us how your approach is consistent with all of your obligations, in your circumstances
  - you may need to obtain legal advice
- proposed timeframe for payment;
- proposed communications package and timeframe for communication with unit holders and former unit holders affected by the error;
- proposals to correct published information about unit prices and performance, where relevant; and
- timeframe and process for system rectification to prevent future errors.

### Principles Relating to the Compensation of Unit Pricing Errors

When considering the need for compensation in the circumstances of your fund, you must take all relevant legal obligations into account and be able to demonstrate how you have addressed each of those obligations. You have duties and obligations under both common law and statute.



### Guide to good practice in managing errors and compensation (cont.)

We note that, historically, when determining whether to pay compensation and to whom, product providers have considered whether it is consistent with their obligations to set a threshold, or to differentiate between unit holders – for example, based on the size of the loss, or the costs of compensation.

Consistent with the objective of seeking fair and equitable treatment of 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;
- all ongoing unit holders must be fully compensated, regardless of the amount;
- subject to the application of any fixed dollar minimum, where compensation is payable, it is payable to everyone who was a unit holder at the time the error occurred;
- you are responsible for all administrative expenses incurred in rectifying the error (however, see below in relation to not-for-profit superannuation funds);
- in determining compensation, reasonable efforts should be made to return all unit holders (including the fund and the ongoing unit holders) to the financial position that would have existed if the error had not occurred;
- you must not benefit from an error in unit pricing – where it is not possible to restore all parties to the position that would have applied if the error had not occurred, you are responsible for meeting any deficit, while any surplus should remain in the fund for the benefit of ongoing unit holders; and
- in the case of superannuation funds, you are responsible to ensure that there is no breach of the SIS Act.

You have a responsibility to prevent unit pricing errors. You also have a duty to act in the best interests of unit holders as a whole. You must act honestly, diligently and impartially. As between unit holders, you must treat unit holders of the same class equally and unit holders in different classes fairly. You need to take particular care when determining compliance with your obligations.



## Guide to good practice in managing errors and compensation (cont.)

When determining compensation in the circumstances of your fund (including not-for-profit superannuation funds), you must take all relevant legal obligations into account and be able to demonstrate how you have reconciled those obligations with your plans for rectifying the error and compensating affected members. In doing so, you should note that the allowance by the regulators of fixed dollar minima on compensation amounts to exited members does not affect third party rights against you in relation to non-compensation.

However, we acknowledge that, when determining compliance with obligations, there are a number of factors to be considered and balanced. As noted earlier in this guide, 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.

### When is Compensation Payable

When determining whether compensation is payable, you need to consider the impact on each individual unit holder of one or more unresolved errors. You need to:

- compare the value that would have accumulated if the unresolved error(s) had not arisen with the value that accumulated in the presence of the error(s), from the date the error(s) started to the date the effect of the error(s) ceased. You can regard an error as resolved if it was appropriately identified and addressed within the terms of reasonable error management policy and reasonable compensation policy in effect at that time;
- if the difference is equal to or greater than 0.3% (30 basis points) of the value that would have accumulated without the error, pay compensation; and
- if the difference is less than 0.3%, consider whether compensation should be paid. For example:
  - this may depend on the type of asset. It may be appropriate to compensate smaller errors for some products, for example, cash management trusts;



## Guide to good practice in managing errors and compensation (cont.)

- where an error arises due to miscalculation of fees, it must be compensated in all cases; and
- there may be other circumstances when it is appropriate to compensate when the difference is less than 0.3%. You need to consider the circumstances and your obligations in each case.

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.

We also note that in some cases product providers may themselves be paid compensation. 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 product provider in a layered sequence of product providers. Compensation might be payable by one product provider to another, who would then independently determine any need to compensate its own unit holders.

### Payments to Exited Members

For exited unit holders a fixed dollar minimum can apply to compensation amounts. The following principles apply:

- compensation should be paid where the amount of compensation is \$20 and above. You can compensate below this level if you wish; and
- if you apply a fixed dollar minimum, then disclosure must be made on your website and in the annual financial report for the relevant fund.

For funds with crediting rates rather than unit pricing the principles above also apply for exited members.



## Obligations relevant to unit pricing

The entities most likely to provide unit priced products in Australia are life companies, superannuation providers and fund managers. All such entities are subject to a range of duties when providing unit priced products both at common law and under relevant statutes. Some of the specific statutory duties and obligations are briefly outlined below.

The information in this chapter 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.

### 7.1 Entities regulated under the *Superannuation Industry (Supervision) Act 1993*

Section 52 of the *Superannuation Industry (Supervision) Act 1993* 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 to unit pricing:

- to act honestly in all matters concerning the entity: see s52(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: see s52(2)(b)
- to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries: see 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: see s52(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: see s52(2)(g)
- to allow a beneficiary access to prescribed information, namely the information and documents that are available to a concerned person under s1017C of the *Corporations Act 2001*: see 52(2)(h).

The *Superannuation Industry (Supervision) Act 1993* 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. Since 1 July 2004, all new trustees have been 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: see APRA Superannuation Guidance SGN Note 140.1 *Adequacy of Resources*, SGN 130.1 *Outsourcing* and SGN 120.1 *Risk Management*.

## 7.2 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 financial services under an AFS licence include:

- doing all things necessary to ensure the services are provided efficiently, honestly and fairly: see s912A(1)(a)
- having adequate arrangements to manage conflicts of interest: see s912A(1)(aa)
- having adequate financial, technological and human resources, unless the licensee is a body regulated by APRA: see s912A(1)(d)
- maintaining the competence to provide those services: see s912A(1)(e)
- ensuring that representatives are adequately trained and competent to provide those services: see s912A(1)(f)
- having complying dispute resolution systems where services are provided to retail clients: see s912A(1)(g)
- having adequate risk management systems, unless the licensee is a body regulated by APRA: see s912A(1)(h).

### Responsible entities of registered managed investment schemes

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

- acting honestly: see s601FC(1)(a)
- exercising the degree of care and diligence that a reasonable person would exercise in that position: see 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: see s601FC(1)(c)
- treating members who hold interests in the same class equally and members who hold interests in different classes fairly: see s601FC(1)(d)
- ensuring that scheme property is valued at regular intervals appropriate to the nature of the property: see s601FC(1)(j)
- ensuring that all payments out of the scheme property are made in accordance with the scheme's constitution and with the *Corporations Act 2001*: see s601FC(1)(k)
- ensuring that the constitution of a registered scheme makes adequate provision for matters including consideration to be paid to acquire interests in a scheme, withdrawal from a scheme, and dealing with complaints: see s601GA and ASIC Regulatory Guide 134 *Managed investments: Constitutions* [RG 134].

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

### Directors and other officers

Directors and other officers of a corporation have obligations including the requirements to exercise their powers and discharge their duties:

- with the degree of care and diligence that a reasonable person would exercise in those circumstances: see s180
- In good faith in the best interests of the corporation: see s181.

## 7.3 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 also regulated under the *Life Insurance Act 1995*. The *Life Insurance Act 1995* imposes a number of obligations that are generally relevant, although not specific, to unit priced products.

These include the 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: see s48(2).

In addition, s116 of the *Life Insurance Act 1995* 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.

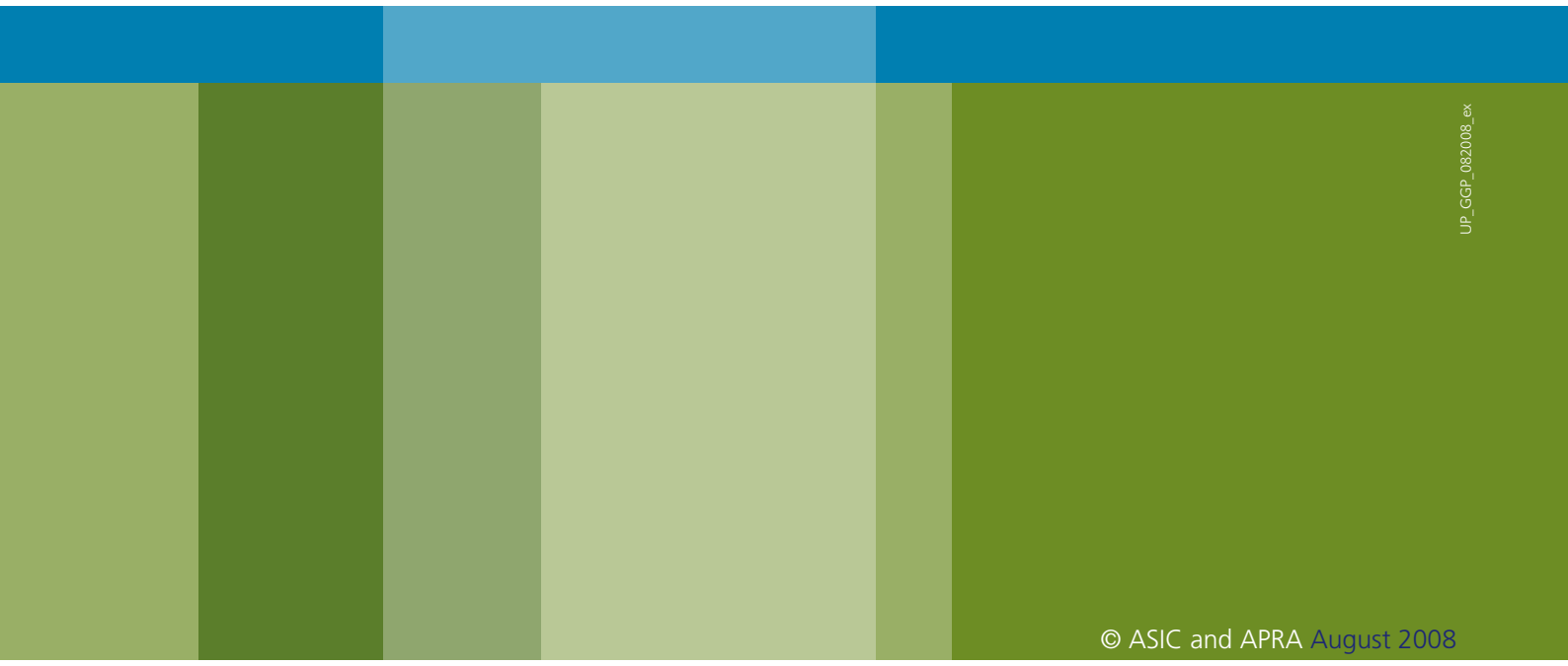


## Key terms

<b>AASB</b>	Australian Accounting Standards Board
<b>APRA</b>	Australian Prudential Regulation Authority
<b>ASIC</b>	Australian Securities & Investments Commission
<b>ATO</b>	Australian Taxation Office
<b>fund</b>	pooled investment product
<b>governing documents</b>	<p>These documents set out the rights and obligations of product providers and unit holders and include:</p> <ul style="list-style-type: none"><li>■ scheme constitutions and compliance plans for managed investment schemes</li><li>■ insurance policies for investment life insurance products</li><li>■ governing rules of the fund, including the trust deed, for superannuation funds.</li></ul> <p>Statements made in PDSs and other documents relating to the product need to be consistent with statements in the governing documents.</p>
<b>independent review</b>	<p>Independent reviews can be undertaken by parties that are not directly involved in the unit pricing function. For example, independent review may be undertaken by internal audit, the compliance unit, the risk management unit, external auditors, actuaries or by other external advisers, depending on the circumstances. Product providers must decide who is the appropriate entity to undertake independent review, based on the circumstances and taking account of legal obligations.</p>
<b>PDS</b>	Product Disclosure Statement
<b>periodic review</b>	<p>The frequency and nature of reviews are at the discretion of the product provider, based on the circumstances and taking account of legal obligations</p>



<b>product</b>	Unit priced products include: <ul style="list-style-type: none"><li>■ investment life insurance policies</li><li>■ allocated annuity and pension products provided by life insurance companies</li><li>■ superannuation funds</li><li>■ wholesale or retail managed investment schemes</li><li>■ pooled superannuation trusts.</li></ul>
<b>product provider</b>	Providers of unit priced products include life companies offering investment life products and superannuation, allocated annuity and pension products, superannuation trustees offering superannuation funds, responsible entities offering registered managed investment schemes and other fund managers offering managed investment schemes or pooled superannuation trusts.
<b>service provider</b>	Where a product provider decides to outsource certain functions, those functions are performed by a service provider.
<b>superannuation fund</b>	Registrable superannuation entity as defined in s10 of the <i>Superannuation Industry (Supervision) Act 1993</i>
<b>the regulators</b>	APRA and ASIC
<b>we/us/our</b>	the regulators
<b>you/your</b>	product provider



UP\_GGP\_082008\_ex

© ASIC and APRA August 2008