

# Collective Investment Schemes in Nigeria

5-Year Strategic Master plan & Roadmap

(2013 – 2018)

Fund Managers Association of Nigeria©  
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# TABLE OF CONTENTS

<b>1 INTRODUCTION .....</b>	<b>4</b>
<b>1.1 THE VISION .....</b>	<b>4</b>
<b>1.2 THE GOAL .....</b>	<b>4</b>
<b>1.4 THE GAP – WHERE WE ARE.....</b>	<b>6</b>
<b>1.5 CHALLENGES.....</b>	
.....	<b>8</b>
<b>1.6 REGULATORY AND LEGAL FRAMEWORK.....</b>	<b>11</b>
<b>1.7 FINANCIAL ARCHITECTURE .....</b>	<b>12</b>
<b>1.8 TAXATION .....</b>	<b>19</b>
<b>2 THE PLAN- OPERATIONS.....</b>	<b>21</b>
<b>2.1 LEGAL FRAMEWORK .....</b>	<b>21</b>
<b>■ DISTINCTION BETWEEN ISSUER AND FUND MANAGER .....</b>	<b>21</b>
<b>■ MORE ELABORATE PROVISIONS FOR REAL ESTATE INVESTMENT TRUST.....</b>	<b>21</b>
<b>■ REDEMPTION OF UNITS .....</b>	<b>21</b>
<b>■ SEGREGATION OF LIABILITIES UNDER UMBRELLA FUNDS .....</b>	<b>22</b>
<b>2.1.2 SEC REGULATIONS (SUGGESTED AMENDMENTS) .....</b>	<b>22</b>
<b>■ REAL ESTATE INVESTMENT SCHEMES .....</b>	<b>22</b>
<b>■ DRAFT RULE F3 PRIVATE PLACEMENT BY PUBLIC COMPANIES AND COLLECTIVE INVESTMENT SCHEMES .....</b>	<b>23</b>
<b>■ CUSTODIAN .....</b>	<b>23</b>
<b>2.2 OBSERVATIONS ON THE SEC WEBSITE .....</b>	<b>24</b>
<b>2.3 FUND OBJECTIVES .....</b>	<b>26</b>
<b>RECOMMENDATIONS .....</b>	<b>26</b>
<b>2.3.2 ACTIONS REQUIRED: SHORT TERM – ≤ 1 YEAR.....</b>	<b>26</b>
<b>2.4 INVESTMENT STRATEGY .....</b>	<b>26</b>
<b>2.4.1 RECOMMENDATIONS .....</b>	<b>26</b>
<b>ACTION REQUIRED: SHORT TERM – ≤ 1 YEAR.....</b>	<b>27</b>

<b>2.5 INVESTMENT POLICY .....</b>	<b>27</b>
2.5.2 RECOMMENDATIONS.....	27
<b>2.6 VALUATION &amp; PERFORMANCE EVALUATION .....</b>	<b>27</b>
2.6.2 RECOMMENDATIONS.....	27
<b>2.7 PRICING .....</b>	<b>28</b>
2.7.1 RECOMMENDATIONS.....	28
<b>2.8 PERFORMANCE EVALUATION.....</b>	<b>28</b>
<b>2.8.1 PERFORMANCE MEASUREMENT .....</b>	<b>29</b>
ACTIONS REQUIRED: SHORT TERM – ≤ 1 YEAR .....	29
2.8.2 PERFORMANCE ATTRIBUTION.....	30
ACTIONS REQUIRED: SHORT TERM – ≤ 1 YEAR .....	30
2.8.3 PERFORMANCE APPRAISAL .....	31
ACTIONS REQUIRED: SHORT TERM – ≤ 1 YEAR .....	31
ACTION REQUIRED: MEDIUM TERM – ≤ 3 YEARS .....	32
<b>3. PROMOTING AWARENESS AND CONFIDENCE IN THE CIS INDUSTRY.....</b>	<b>33</b>
<b>3.1 STANDARDS, PRINCIPLES &amp; BEST PRACTICE .....</b>	<b>34</b>
3.1.1 TRANSPARENCY & DISCLOSURE.....	34
<b>3.2 GOVERNANCE.....</b>	<b>ERROR! BOOKMARK NOT DEFINED.</b>
<b>3.3 RISK</b>	
<b>MANAGEMENT.....</b>	
.....40	
<b>3.4 INVESTOR EDUCATION.....</b>	<b>41</b>
<b>4. MARKETING PLAN.....</b>	<b>43</b>
<b>5 THE ROADMAP - CRITICAL FACTORS TO CONSIDER.....</b>	<b>48</b>

# **1 Introduction**

## **1.1 The Vision**

The vision of the Fund Managers Association of Nigeria is to develop a multi-trillion naira collective investment scheme industry in Nigeria by 2018.

## **1.2 The Goal**

In support of our vision, we have identified three sets of goals: quick wins for attainment within a one-year period, short-term goals for attainment within 1-2 years, and the last set of goals to be achieved within 3-5 years.

## **1.3 Current and Potential Market Size**

The table below illustrates the developments in the market from 2002 - 2012.

<b>Year</b>	<b>Registered Funds</b>	<b>NAV Existing N' billion</b>	<b>New Funds Inflow &amp; Capital Gain N' billion</b>	<b>Aggregate N' billion</b>
2002	14	40.6	-	40.6
2003	15	40.6	0.4	40.9
2004	17	40.9	5.3	46.2
2005	17	46.2	-	46.2
2006	24	46.2	10.2	56.4
2007	29	56.33	9.6	65.9
2008	38	65.85	18.6	84.5
2009	41	84.41	14.5	98.9
2010	43	98.92	9.6	108.6
2011	43	94.4	(14.2)	80.2
2012	52	85.1	6.42	91.52

In summary, over the past decade the market has grown by 112.2% which represents an annual growth rate of 11.2%. However within the same period, the GDP per capita on a Purchasing Power Parity basis increased from \$875 to \$2,600 representing a 197% growth

and an average annual growth rate of 19.7% despite an average annual GDP growth rate of 4.71%. This implies that the rapid increase in personal incomes as well as attendant increase in propensity to save and invest far outpaced new investments by the retail market in mutual funds.

Consequently, it can be deduced that the majority of investors made direct investments into the capital market than through managed funds; by extension, these investors would have been negatively affected by the downturn in the market that occurred within the period 2008-2012 and as such, their confidence in the capital market would have been eroded.

Currently, the number of potential retail investors in Nigeria is about 4.5 million (representing the number currently making contributory pension). These are investors who currently appreciate the effect of savings and investment and have been doing so over the past seven years and who may be incentivized to invest a minimum of ₦50,000.00 a year into a managed fund .

We estimate that the potential annual inflows into mutual fund will be about N225 billion in additional inflows annually, that is assuming each of the potential 4.5 million investors make a minimum annual contribution of ₦50,000.00

Consequently, given this number, the CIS is currently achieving only 5.6% of its capacity in terms of market penetration.

### 1.3.1 Current Market Participants

The Fund/Investment management market is dominated by two sets of regulated players with the following differing characteristics:

Regulator	SEC Regulated	PENCOM Regulated
Players	Fund Managers	Pension Fund Administrators (PFA)
Products Focus	CIS	Retirement Savings Accounts (RSA) & Additional Voluntary Contributions (AVC)
Number of Registered Fund Managers	28	38
Number of Collective Investment Schemes	52	-
Number of Custodians	4	4
Number of Customers	250,000	4.5 million
Total Assets Under Management	₦91.52 billion	₦1.17 trillion
Age of Industry	22 years	7 years

Average Growth rate	11.2%	88.9%
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The similarity between the Securities & Exchange Commission (SEC) and the National Pension Commission (PENCOM) regulated schemes is that both are essentially fund managers with the value of their assets influenced by developments in the macro-environment. However, for the PFAs, contributions to the scheme by subscribers are mandatory.

The table above depicts the extent to which proper alignment of regulation and healthy competition can spur and sustain growth and customer value creation within the asset management industry.

#### 1.4 The Gap – Where We Are

Today there are 45 collective investment schemes<sup>1</sup> with a combined NAV of N87.3 billion (\$560.11m)<sup>2</sup> managed by 24 Securities and Exchange Commission (SEC) approved Fund Managers. This compares to over 3000 and 130 mutual funds in India and Pakistan respectively; countries that have comparable GDP per capita to Nigeria and in the case of Pakistan is similarly sized both in population and in gross output. The structure of the industry in these countries is also similar with key players—fund managers, custodians, brokers, registrars etc.—playing similar roles.

	GDP PER CAPITA	
	2010	2011
Pakistan	1018.87	1194.33
India	1375.39	1488.52
Nigeria	1242.48	1452.09

Source: World Bank Data;

Nigeria still has an abysmally low penetration of mutual funds which we believe is largely linked to the overall poor level of financial intermediation in the economy. Weak intermediation is largely a function of volatile macro-economic conditions (especially high inflation) which discourages capital formation; underdeveloped capital markets, embryonic institutional investment industry and weak incentives within the Nigerian banking system to offer relatively high-yielding savings products. The table below shows comparative development of Nigeria's funds industry relative to banking services penetration. Notably,

<sup>1</sup> As at July 27, 2012

<sup>2</sup> \$1=155.80

if NAV to GDP in Nigeria rose to 1% like some of its peers, NAV will be about N320bn (\$2bn), over 250% above the current figure.

Countries	Access to Bank Accounts	NAV TO GDP 2011
US	92%	77.00%
UK	90%	33.60%
ARGENTINA	30%	1.50%
PAKISTAN	44%	1.40%
PHILIPINES	27%	1.10%
INDIA	30%	4.70%
SOUTH AFRICA	49%	30.60%
NIGERIA	21%	0.20%

Sources: World Bank, UN Analytical, SEC Nigeria

While mutual funds' NAV have been on a growth path in recent years, accretion appears to be substantially due more to the increase in value of underlying assets than new inflows. In addition, despite its much lower base, Nigeria's industry NAV growth still lags growth rates in Pakistan with similar per capita and gross GDP levels, suggesting that the industry is still yet to gain traction. Significantly, since Pakistan shares many similarities with Nigeria in terms of macro- and micro economic conditions, demographics etc, this suggests that the impediments to industry growth in Nigeria are mostly structural.

	NAV (USD 'mln) and % CHANGE					
	Q3,2011	Q4,2011	Q1,2012	% Change Q4,2011	% Change Q1, 2012	% Average % change
<b>Nigeria</b>	444	473	557	6.5%	17.8%	12.1%
<b>India</b>	102,183	87,519	84,044	-14.4%	-4.0%	-9.2%
<b>Pakistan</b>	2,560	2,984	3,419	16.6%	14.6%	15.6%

Source: SEC Nigeria; ICI Global; ARM Research

## 1.5 CHALLENGES

**Operations - Cost of Doing Business:** The prohibitive costs of financial transactions are a clear impediment to development of the funds industry. Much of these costs are structural in nature. Lack of power is a major cost that all businesses in Nigeria have to contend with. India for instance, has constant power for the most part. The next cost is the structure of the mutual fund industry and the variety of participants that are not necessary though this is discussed in some detail later in the document.

According to Ease of Doing Business ranking 2012<sup>3</sup>, Nigeria is placed 133 out of 183 economies sampled, below Pakistan at 105 and India (132). In addition to these, the mutual fund industry incurs costs such as, initial set-up cost (a percentage of the fund size), shareholder transaction cost, investment advisory, brokerage fees, custodial, marketing and distribution expenses. Generally, these costs increase operational expense and are usually borne (directly or obliquely) by the funds, negatively impacting potential return as reflected in relative expense ratios in the comparable economies below<sup>4</sup>:

REGULATORY CAP FOR EXPENSE RATIO IN INDIA <sup>5</sup>		
Funds of Funds	Total expense not to exceed 2.50%	
Index Funds	Total expense not to exceed 1.50%	
	Other Schemes	Debt Schemes
Up to 100m rupees (\$1.835m)	2.50%	2.25%
On the next 300m rupees (\$5.505m)	2.25%	2.00%
On the next 300m rupees (\$5.505m)	2.00%	1.75%

<sup>3</sup> Doing Business is a part of World Bank Group and the data is based on objective measures of business regulations and their enforcement.

<sup>4</sup> Regulatory cap for expense ratio in Nigeria is 5 %

<sup>5</sup> Calculation is to be based on average daily or weekly net average value (NAV) (depending on how fund is calculated).

Limits exclude issue or redemption expenses. A new regulation is expected to increase the limit to about 3% - Source: The Economic Times – 24/08/2012

On the balance	1.75%	1.50%
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Source: SEBI (Mutual Funds) Regulations, 1996

PAKISTAN RATIO	EXPENSE		ASSETS
	EXPENSE RATIO		
JS ISLAMIC FUND	3.06		2.7089 bn rupees (\$49.69m)
UNIT TRUST OF PAKISTAN	2.54		13.6687bn rupees (\$250.85m)
ASKARI HIGH YEILD	1.77		12.9515 bn rupees (\$237.68m)
JS FUND OF FUNDS	0.88		4.7928 bn rupees (\$87.94m)

Source: Bloomberg.com

**Investor awareness:** While 72% literacy<sup>6</sup> level is similar to comparable countries', Nigeria's financial literacy undoubtedly lags far behind peers', largely reflecting weak financial intermediation highlighted earlier. Historical underdevelopment of capital markets has created limited access to and therefore incentives to learn about—formal savings vehicles.

**Structure of institutional investment industry:** Nigeria is yet to attain the integrated structure of financial industry, evident in more developed markets, which cascades links between the front-end (e.g. insurance and pensions industry that cater to risk sharing and long term savings generation) through to the back-end (asset management and brokerage that intermediate with economy). The weak links between these segments of the financial market, which arise from underdeveloped financial super-structure, impedes capital formation and financial specialisation and is partly responsible for absence of concerted action in promoting savings in the economy by financial sector operators.

Also related to this factor is the lack of a framework to leverage on economies of scale to address costs in the funds industry. Since a charge differential will exist between private and institutional clients with much large asset bases and greater pricing power, the emergence of a feeder fund structure may be an effective way to address this problem.

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<sup>6</sup> World Bank, 2010

However, this development will require close collaboration and significant regulatory and institutional support across the financial industry.

**Product development:** There is also strong indication that the breadth of products on offer is grossly inadequate to cater to wide-ranging financial needs. There are only 7 broad categories of mutual funds in Nigeria compared to 17 in Pakistan (8 categories are Islamic based) and hundreds in more developed markets. Clearly, the lack of scope in the Nigerian funds industry means that it will attract a limited range of investors, but is also a fundamental reflection of shallowness of capital markets and weaknesses in financial market architecture, both of which also need to be meaningfully addressed in any efforts to increase penetration of financial services.

**Institutional capacity:** The significant gaps we have highlighted in the industry suggest a strong need for institutional support in helping build professionalism within the industry. The key aim of this is to help bridge the gap in investor knowledge by encouraging the emergence of a cadre of professional Independent Financial Advisers (IFAs) to act as trusted intermediaries in guiding investment decisions in highly uncertain financial markets.

The role of IFAs will be to objectively suggest to investors, types of assets to invest in and also recommend a particular mutual fund that is a good match for the client's risk tolerance as well as financial goals. IFAs will serve three key purposes; they protect investors against the risk of loss of investment capital in an environment where sound investment knowledge is still scarce; drive investor education and awareness; and, drive the mutual funds to perform better both in terms of returns and transparency since investment opinion of IFAs are expected to be objective and independent. The role of the regulators would be to create and enforce appropriate and minimum standards for professionals in this role.

**Minimum Investment:** Also, with almost 70% of the Nigeria population living below the poverty line, the minimum required investment for most mutual fund serves as a barrier to growth of the mutual fund industry. Though funds with minimum investment of N5,000 (~\$32.0) are now available, a vast majority require an investment of at least N50,000 (~\$320.0) and subsequent monthly contributions as high as N10,000. This high entry level, clearly excludes a significant portion of the Nigerian population. In India, the minimum required to invest in mutual funds is generally 5000 rupees (~\$92.0<sup>7</sup>), with some as low as 500 rupees (~\$9.2). Monthly contributions are as low 100 rupees (\$1.83).

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<sup>7</sup> \$1=54.49 rupees

## **High Rates on Money Market Securities**

Generally, the more investors can earn on less volatile financial instruments, the lower the demand for equities and equity based mutual funds, particularly among institutional investors.

With yields on government money market securities as high as 17%, equities based mutual funds are likely to suffer. 44% of mutual funds in Nigeria are equity based and the overall industry has suffered for this lack of breadth. However, funds that channel capital to long term instruments are a critical segment of a robust and healthy financial framework.

It is in this context that action of monetary authorities which aims to create high yields in funding markets as a means of controlling systemic liquidity has the very counterproductive impact of creating a disincentive to long term savings and stunting capital market development. Greater acknowledgement, by monetary authorities, of the critical role of capital formation via markets for long term savings and willingness to address this imperative is a critical piece of efforts to build a robust economy.

### **1.6 Regulatory and Legal Framework**

The regulatory benchmarks and support offered by SEC rules and the ISA 2007 on collective investment schemes beyond modalities for setting up a new fund are thin for the industry's critical role. Given the growth potential of the industry, a regulation similar to India's SEBI (mutual funds) regulations, 1996, which focus only on mutual funds might be necessary to develop targeted policies that take into consideration the unique nature of the funds industry as a vehicle for capital formation.

The enforcement of the provisions protecting investors against self dealing, conflict of interest, and undisclosed risks of many types need to be **visible** to the ordinary investor. The operations of most mutual funds in Nigeria fall short of the transparency and benchmarking standards available in many developed and developing markets. Successful development of mutual funds require a robust and effective regulatory framework that is particularly focused on (and important to) building investor confidence<sup>8</sup>.

We would, in the body of this document, provide suggestions on certain provisions of the SEC rules and the ISA 2007 which we believe should be reviewed.

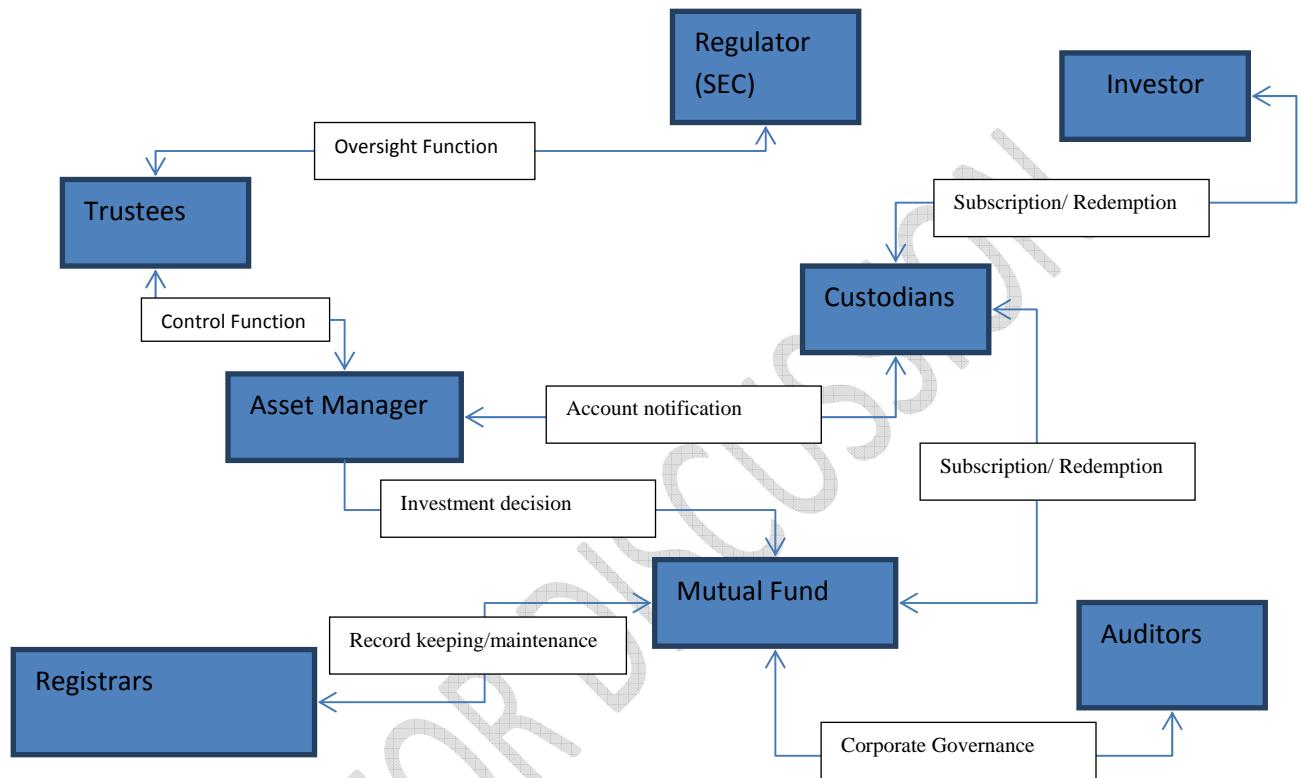
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<sup>8</sup> Beneficial regulation has been attributed as a key factor behind the strong growth of the US mutual fund industry (Reid 2000).

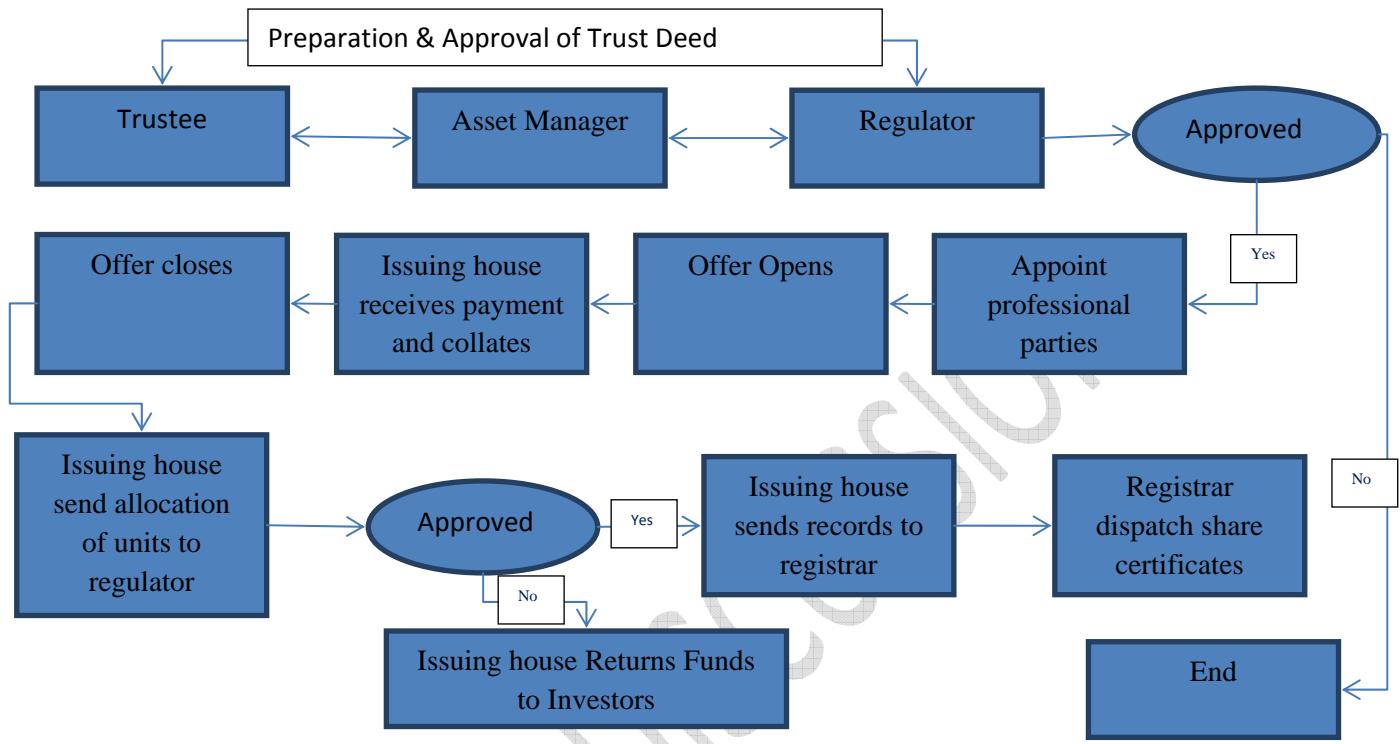
## 1.7 Financial Architecture

### Process Flow for Collective Investment Schemes (“CIS”)

#### Parties to the Scheme



## Fund Set-up/IPO



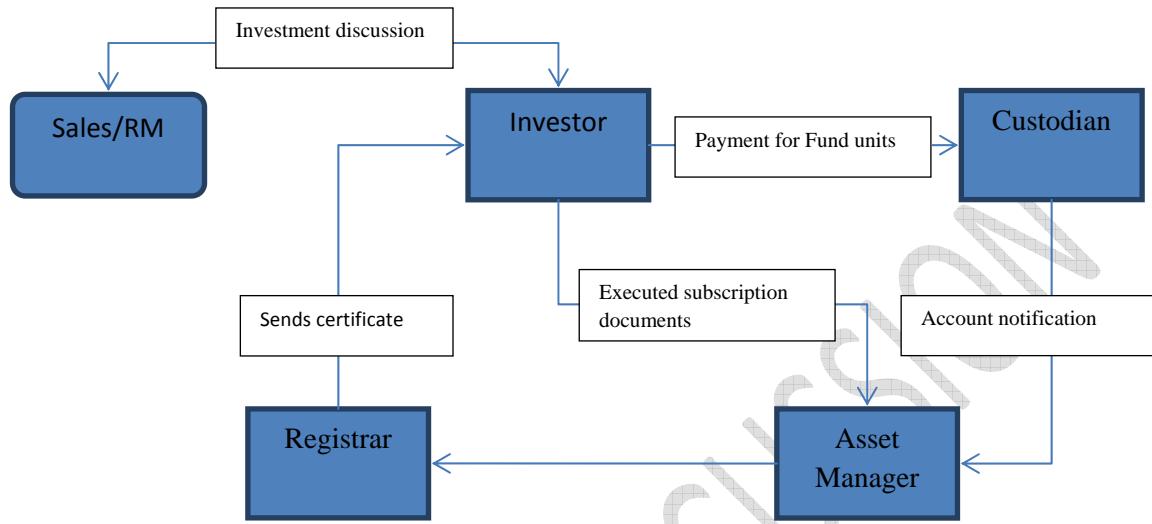
Professional parties include: reporting accountant, brokers, financial advisers, legal advisers/solicitors to the offer, and legal advisers to the Trustee. The number of parties should be reduced to minimize the cost of set up.

### Cost associated with an offering

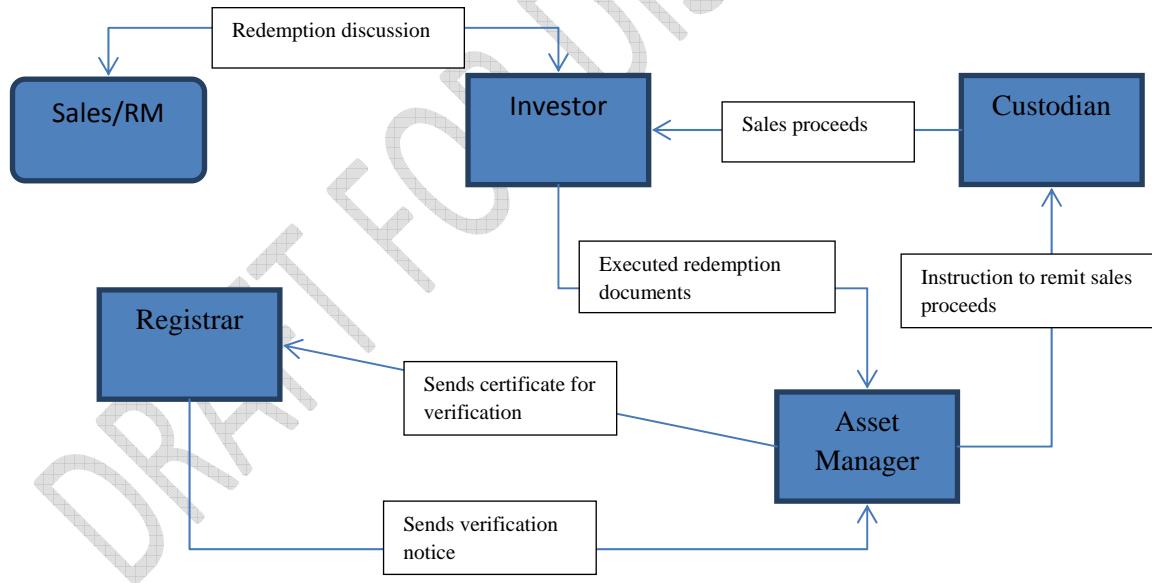
1. Issuing house – up to 1.35% of offer size (negotiable)
2. Solicitors – N15m (negotiable)
3. Auditors – (subject to existing retainer agreements)
4. Stockbrokers – N10m (negotiable)
5. Reporting Accountants – N10m (negotiable)
6. Registrars – N10m (negotiable)
7. Receiving Agents - 0.75% brokerage commission

## Subscription and Redemption

### Subscription

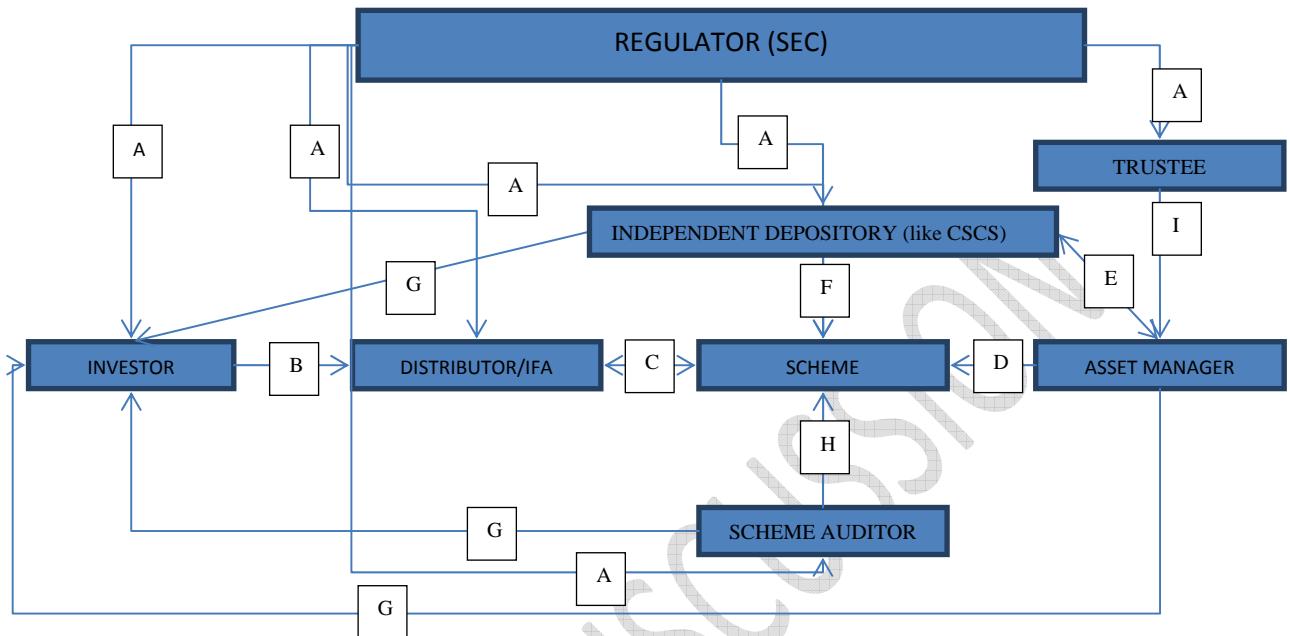


### Redemption



## Proposed Process:

Similar to the Contractual Model I & II adopted by Brazil, UK, France, Germany& Portugal



- A. Global supervision of the CIS activities and of the respective key players with the main goal of protecting Unitholders best interests
- B. Placement of orders for subscription/redemption of CIS Units.
- C. Inflow/outflow of money and issue/amortization of Units.
- D. Day-to-day management of the CIS portfolio.
- E. Duty of reporting and shared responsibility towards unitholders.
- F. Oversight of CIS operations and safekeeping of assets.
- G. Protection of CIS Unitholders best interests.
- H. Independent review of CIS key elements.
- I. Oversight of the operations of the Asset Manager and fiduciary duties towards the property of CIS assets.

**\*\*NB: The depository would perform the joint functions of registrars and custodians. We believe this will provide a platform for mergers between registrars and custodians which should lead to more efficient and effective discharge of their duties.**

With this model, the depository maintains governance of the scheme. It ensures safekeeping of the scheme's assets. The United Kingdom and France allow for the appointment of the Board to perform the oversight function of the scheme, while Portugal, Brazil and Germany vest the oversight function on the depository. The trustee would be saddled with similar responsibilities as the Board of Directors in this model.

We propose that the depository need not be an independent entity, but should have specific requirements concerning the segregation of functions and activities between it and the operators similar to the Brazilian structure. The depository could be an entity sanctioned by SEC and having the operators as stakeholders. We also propose the adoption of the Portuguese model to enable the depository oversee the CIS operators and activities as well as provide custody of the scheme assets.

## **DEPOSITORY**

**Option 1:** The registrars and custodians can engage in strategic alliances to operate as single entities performing the broader function of the depositories. These two entities already have the expertise in both record keeping and safekeeping of assets and should technically be capable of functioning as the depository. With this option, the CIS industry would benefit from an array of depositories which should enhance efficiency and effectiveness.

**Option 2:** FMAN can approach CSCS to act as a depository. CSCS has a history of carrying out this function with the Nigerian Stock Exchange. The only challenge with this option is the inflexible nature of their operations.

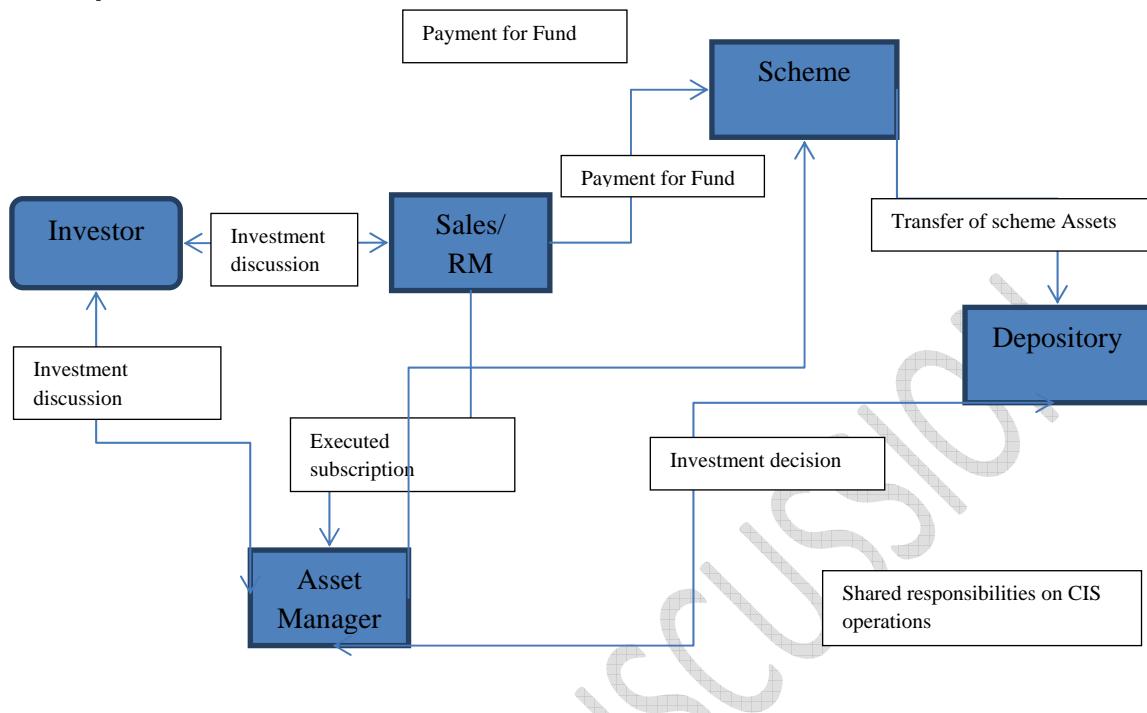
**Option 3:** FMAN members can collaborate to form a central depository in which they are all stakeholders. A technical committee should be inaugurated to set up as well as oversee the activities of the depository. The Securities and Exchange Commission should also be called upon to support the establishment of the depository.

### **Our Proposal**

FMAN should provide the custodians and registrars with the possible options with a target implementation period of 1-2 years. However, if the registrars are unwilling to make the required investments, FMAN should focus on option 3. Option 2 should be last resort.

DRAFT FOR INFORMATION

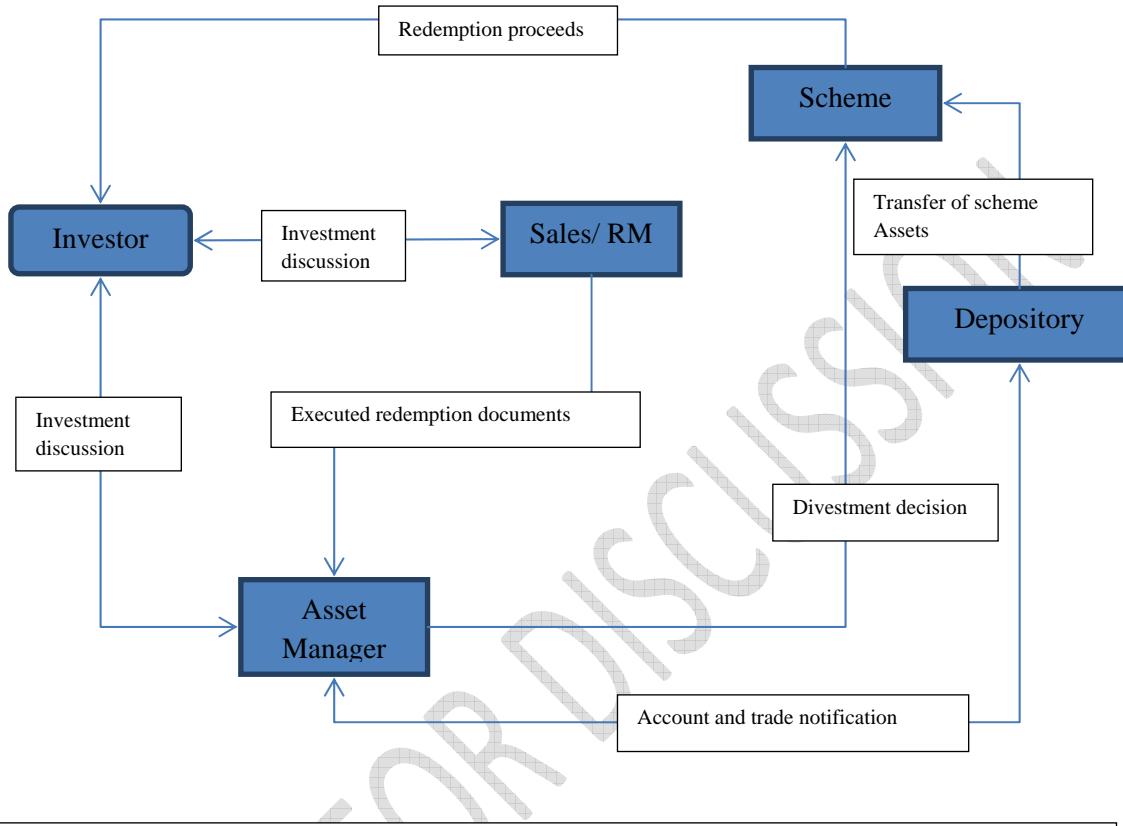
## Subscription



### Action points

- Investor approaches sales representative or the Asset manager for a possible investment in the scheme
- Sales representative sends subscription documentation to the Asset Manager
- Investor/ Sales agent makes payment for the CIS to the scheme's settlement account
- Asset Manager executes the investment in the underlying securities on behalf of the scheme
- The depository maintains custody of the scheme's assets
- Shared responsibilities between the depository and the asset manager on the operations of the CIS

## Redemption



### Action points

- Investor approaches sales representative or the Asset manager for a possible divestment in the scheme
- Sales representative sends redemption documentation to the Asset Manager
- Asset Manager executes the divestment in the underlying securities on behalf of the scheme
- The depository transfers the scheme's assets (cash) to the scheme's settlement bank
- The Investor receives the proceeds of the divestment from the scheme's settlement bank.
- Shared responsibilities between the depository and the asset manager on the operations of the CIS

## **1.8 Taxation**

### **The Issue**

The Fund Managers of the Unit Trusts have recently been visited by the officials of the Federal Inland Revenue Service. The tax authority has claimed that collective investment schemes controlled by them (such as the Unit Trusts) are subject to tax which should be imposed under their jurisdiction. It is our opinion that these schemes do not fall under their jurisdiction. We have set out our research, which attempts to ascertain whether or not the collective investment schemes are subject to tax and if so by whom.

The three relevant Acts that would be considered are:

- (i.) The Companies Income Tax Act (as amended) (CIT)
- (ii.) The Personal Income Tax (as amended) (PITA)
- (iii.) The Capital Gains Tax Act (CGT). This is treated in a similar way and is determined by whether the tax is being borne by a person or a company.

Two issues always need to be borne in mind. The first is whether the business unit is covered under the scope of these acts. The second is the extent to which it is so covered.

### **Companies Income Tax Act**

This tax is specifically levied on the income of companies. The phrase, "charge to tax" is set out in Section 9 of the Act and it specifies companies only.

A unit trust is managed by and controlled by a fund manager who is, under the regulations of the Investment and Securities Act 2007. The Unit Trust is not the company and indeed the Act segregates the affairs of the company from that of the trust.

The business of managing the funds is therefore independent of the business of the unit trust. This has been stressed by:

- (a) the custodian arrangements over the assets (fund manager does not own or control the assets)
- (b) the trustee who holds title to such does not hold it as a beneficiary. The trustee holds such title on behalf of the unit holders.

The income is therefore not taxable in the hands of the fund manager (company) as it does not own the assets or receive the dividend or share in any profit at the point of receipt. Companies Income Tax cannot be levied on this income as it is therefore not covered by the scope of the Act.

### **Personal income Tax**

Section 1(b) of the Personal income Tax Act states that the tax can be imposed on a trustee or an estate which shall be determined under the provisions of the Act.

Section 2 states from whom taxes can be collected. Kindly note that no power is given to the state to collect taxes from the trustees. Tax is specific and legislation throughout the history clearly states that if the legislation does not state it, it cannot be implied.

Section 2(6) states that in the case of a trustee of any settlement or trusts or estate, tax may only be imposed by the territory of which the tax authority is the relevant tax authority in relation to such settlement trust or estate to the extent of the 2<sup>nd</sup> Schedule of the Act.

Please note that a unit trust is not a settlement or an estate belonging to people who have a beneficial interest in the assets. A unit trust holder only has the right to receive dividends and his capital returned.

Section (1) of the 2<sup>nd</sup> Schedule goes on to state that the income shall be that of the settler if:

- (a) he acquires an immediate exercisable power (not possible under the Trust as the settler or creator of a unit trust can only manage and distribute);
- (b) the settler or person makes use of the income (can only be done through withdrawal in which case he would be assessed);
- (c) the trust can be revoked and the fund manager gains title.
- (d) it has to be noted that the capital does not get derived from the settler but by subscription from the beneficiary of the income.

Unit trusts do not therefore have a settler within the meaning of the tax legislation.

### **Overall Conclusion**

If the trustees/fund managers cannot be liable then who are those that are taxable?

The income is taxed upon the receipt by the unit holders of the dividends paid out of the profits of the fund. Such dividends can then be subject to tax in accordance with PITA or CITA. Any other form of tax is double taxation of the income which is not allowed under our present laws.

In view of the fact that tax incentives and regulatory factors have played a major part in stimulating the development of in any country, we request that SEC, on behalf of the collective investment schemes, engage the Federal Inland Revenue Service on a proper delineation of the taxes applicable to CIS.

## **2 The Plan- Operations**

### **2.1 Legal Framework**

#### **2.1.1 Investments and Securities Act 2007 (Suggested Amendments)**

- Distinction between Issuer and Fund Manager**

Section 152 of the ISA defines an issuer as the person performing the duties of a manager pursuant to the provisions of the trust deed or other agreement under which the units or securities are issued. This definition would imply that the fund manager of a CIS will always necessarily have to be the issuer of the CIS which is not always the case. Take for instance the case of a REIT, a property company or other primary mortgage institutions who are not registered with the SEC as fund managers may desire to float a REIT and to appoint a fund manager to manage the REIT. In this scenario, the fund manager is not the issuer of the REIT and its functions are limited to management and as such the definition of an issuer as the manager is contradictory in this case. The effect of this distinction becomes clearer in instances where certain obligations are placed on the issuer of the REIT where, in the cases where the issuer and the fund manager are distinct, such obligations should not be performed by the fund manager.

We suggest that the definition of an issuer be reflective of one who registers, distributes, and sells the CIS which may not always be the fund manager.

- More elaborate provisions for Real Estate Investment Trust**

We suggest that the provisions for REIT be removed from Part XIII of the ISA for collective Investment Schemes and made an independent Part of its own with more elaborate provisions. This is the best way to guarantee and preserve its tax free status because that will show that it is not an authorised unit trust and defined under the CITA.

- Redemption of Units**

Redemption of Units as provided in section 166 of the ISA is not consistent with the nature of a close- end investment fund listed under section 171 (1) (e). Providing under section 166 that the fund manager shall be obligated to redeem the units of a securities anytime the holder of such securities demand for it and providing for a criminal sanction under subsection 3 where such redemption is not made will suggest that all authorised schemes for the purpose of the ISA must necessarily be open ended.

- **Segregation of Liabilities under Umbrella Funds**

An umbrella fund is a collective investment scheme structured as a single legal entity with distinct sub-funds which are traded as separate investment funds. For instance, a fund manager may desire to set up a fund to invest in financial services, upon interaction with potential investors, he may find out that some investors are interested solely in the banking sector while others desire to plug in to insurance companies and do not want their monies used for other investment, to take care of the appetite of the various investors, he will set up a main fund which is the financial services fund and then invest in financial services through sub funds that will invest in specific sectors. The investors will hold units of the sub fund and not the main fund.

In line with global trend, it is necessary for there to be a statutory backing for the segregation of the liabilities of the sub-funds under an umbrella fund such that the assets of each sub-fund belong exclusively to that sub-fund, so that they are effectively ring-fenced from the other sub-funds in the umbrella company and the umbrella company itself. This ensures that each sub-fund has segregated liability and the assets of one sub-fund cannot be used to satisfy the liabilities of another sub-fund within the umbrella company or the umbrella company itself, and thus that the insolvency of one sub-fund should not lead to the insolvency of the umbrella company or another sub-fund

#### **2.1.2 SEC Regulations (suggested amendments)**

- **Real Estate Investment Schemes**

Rules 250 – 281 of the SEC Rules which provides for Real Estate Investment Schemes (REIS) were made pursuant to the Securities and Exchange Commission Rules and Regulations Amendment 2006 (2) (SECRR (A) 2006 (2).

The SEC Rules for REIS did not take into cognizance the real estate investment company or trust provided for under Section 193 of the ISA being a rule which came in existence before the enactment of the Act

The REIS under the SEC Rules is in the nature of an authorised unit trust scheme investing solely in real estate. This is akin to section F of the UK's Financial Services (Regulated Schemes) Regulations 1991 which establishes a framework for authorised unit trust structure schemes to be invested in property called property funds.

The current SEC Rules on REIS should be limited to authorised unit trust schemes investing in property while new rules for REIS in line with the ISA should be enacted.

- **Draft Rule F3 Private Placement by Public Companies and Collective Investment Schemes**

The Draft Consolidated Rules of the SEC included Collective Investment Schemes in the heading for Rule F3 dealing with private placement though the body of the rule made no mention of collective investment schemes.

Authorised Unit Trust schemes (“AUTs”) are open ended in nature; regulation of private placement by AUTs is not consistent with its nature. CIS are by their nature investment business i.e. they collect funds for investment as part of their business, regulating a private placement by a CIS goes beyond securities regulation but a regulation of the business of the entity itself.

- **Custodian**

The roles currently performed by custodians of CIS are customarily to be performed by trustees under the Act. However, the ISA permits a delegation of functions by trustee provided such delegation is not an abrogation of their duty and is not to the fund manager. The rule that the custodian be independent of the trustee has no basis in law especially since by the rules the custodian is still expected to perform monitoring roles as the trustee. The role of the custodian should strictly be safe-keeping and nothing more.

- **Review the Table of contents of the Consolidated Rules & Regulations**

The numbering in the table of contents does not match the numbering in the actual body of the document. For example, in the index Part J – Registration of CIS starts with Rule 449 but in the body of the document, Part J starts with Rule 446.

Furthermore, references in the body of the document should be carefully reviewed. Some references are inaccurate.

- For example, Rule 447 references Rule 247 which does not speak to the contents of Rule 447.
- Similarly, Rule 448 & 449 reference Rule 190 which appears irrelevant to the subject covered under Rule 448 & 449.
- Rule 452 (1)(a) references Rule 239(4) but there is no rule 239 (4)
- Rule 452 (1)(h) references rule 247 which does not speak to the contents of Rule 247

There is a conflict between provision of clause (ff) of Rule 459 and Rule 446 with respect to independent members of the Investment Committee of CIS.

Bullet point 5 of Schedule VI with respect to Basis of Computation of Bid and Offer Prices for CIS should simply reference Rule 447 rather than “other relevant approved costs’.

While the Rules and Regulations provides guidelines for REIT, Venture Capital, Money Market Funds, Private Equity it should provide guidelines for equity funds, balanced funds, ethical funds – i.e different categories of the Funds.

With the adoption of IFRS, the provision in the rules on the amortization of initial expense over 5 years should be removed.

## 2.2 Observations on the SEC Website

- Under the CIS section 3 links are currently available:
  1. Registered Fund Managers – information on Fund Manager, name of Fund, Fund Manager's physical and web addresses.
  2. Financial information
    - Net Asset Value of CISs – several excel sheets available.
      - Funds are categorized based on type of fund.
  3. Fund managers monthly investment schedule – categories based on allocation to different asset classes
- While the information on the website is a step in the right direction, additional information (in addition to those suggested in the body of this document) is required for example:
  1. Under Registered Fund Managers, information such as the following should be included:
    - Start date of Funds
    - Nominal Value of units
    - Name of Trustees & Custodians
  2. **Financial information on Funds**
    1. Need for comparability between funds:
      - It is important that investors are able to compare the different offerings to assess suitability to meeting their investment objectives.
      - Comparability of funds can be across different aspects:
        - i. Based on investment objective espoused by Fund Manager.
        - ii. Fund structure – Closed or Open end funds; speaks to liquidity of the funds.
        - iii. Type of assets the Fund Manager intends to hold to achieve the objective of the Fund

- iv. Risk Profile
  - v. Investment style to be followed by Fund – Value, Growth, Market.
  - vi. Investment performance
  - vii. Expense ratios
2. Need to establish proper reporting of:
- Performance
    - i. Standardize the basis for computing rate of returns for CIS.
    - ii. Standardize evaluation period for CIS
    - iii. Introduction of risk adjusted returns over evaluation period.
  - Expense ratios
    - i. Standardize the basis for computation
  - Benchmark
    - i. Introduction of benchmarks. This is important for performance appraisal.
    - ii. Market benchmarks should be agreed between fund managers and the Commission.
    - iii. Fund Manager's benchmark should be appropriate for asset category.
    - iv. Incentive fees should be linked to the appropriate benchmark for asset category as opposed to provision of Rule 459 (k) which provides a blanket 10% benchmark irrespective of the constituents of the investment portfolio.
    - v. Appropriate benchmarking will ensure fund managers are rewarded i.e. incentive fee for investing skills – either style and/or active management.
3. Need to clarify the concerns around taxes for CIS
- This is fundamental to the rationale behind the concept of the CIS for any investor.
4. Other issues
- Need for the SEC to centralize the information received from Fund Managers from weekly, monthly, quarterly, half yearly & annual submissions.

## **2.3 Fund Objectives**

This refers to the goal/purpose to be achieved by the fund over a specified time frame. What is the mission of the Fund? The objectives of the Fund should be expressed along both return and risk objectives with consideration to investment horizon; liquidity; tax considerations; legal & regulatory considerations.

### **Recommendations**

#### **2.3.2 Actions required: Short Term – ≤ 1 year**

- Objectives of existing funds as stated in the prospectus/trust deeds (or amendments) should be summarized and displayed on the SEC website.
- Existing Funds should be made to reword espoused objectives to clearly state return and risk tolerance with considerations to investment horizon; liquidity; tax considerations; legal & regulatory constraints.
- Objectives of new funds should state both return and risk tolerance with considerations to investment horizon; liquidity; tax considerations; legal & regulatory constraints.

## **2.4 Investment Strategy**

This refers to how the fund manager expects to achieve the investment objectives of the Fund. It involves articulating the investment philosophy of the Fund, the asset classes available to achieve this objective and the approach to be followed in investing the funds. It is necessary for the fund manager to articulate its investment philosophy – i.e whether fundamental or technical? value, growth or market? small, medium or large capitalization? What asset classes are available to the manager? Given the investment objectives of the fund, what is its strategic asset allocation?

What approach will the fund pursue – passive, semi active or active strategy?

### **2.4.1 Recommendations**

- It is important to have existing funds and new funds articulate the strategy to be adopted in achieving their investment objective.
- <sup>9</sup>Research studies indicate that investment performance is largely driven by the asset allocation of the investment portfolio.
- Where the strategy to be followed by a fund is properly articulated investors are able to evaluate the strategy over time and determine if this is the appropriate one in achieving their investment objectives.

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<sup>9</sup> CFA Institute - "Brinson, Hood, and Beebower (1986)" "Brinson et al. concluded that asset allocation explained an average 93.6 percent of the variation of returns over time for 91 large U.S. defined benefit pension plans."

### **Action required: Short Term – ≤ 1 year**

- Existing funds should clearly indicate broad principles which will guide how investments are to be made over the life of the fund.

## **2.5 Investment Policy**

This is a combination of the investment objectives with the constraints, philosophy, and strategy to be pursued by the Fund over its life. Encapsulated in a document, the investment policy of the Fund guides both the fund manager and the investor. The investor is able to evaluate the fund based its investment policy. It ensures that the fund manager is to a large degree able to explain the performance achieved by the fund.

### **2.5.2 Recommendations**

- The investment policy of the fund should be made available on the website of the fund manager and a summary provided on SEC's website.
- Changes to the investment policy should be communicated to investors along with the reason(s) for the changes.
- Adherence to the investment policy should be monitored by the SEC.
  - For example, the half yearly returns should include a question that asks if the fund has followed its investment policy and the reason for any deviation if the answer is in the negative.
  - At AGMs of the Fund, investors should be shown how the manager has been consistent with the investment policy of the fund.

## **2.6 Valuation & Performance Evaluation**

There is need for uniformity with respect to methods applied and the consistency of the application of the methods applied in valuing assets held by CIS.

### **2.6.2 Recommendations**

- For comparability, the criteria for the valuation of assets held by CIS should be clearly spelt out.
  - Where there are different methods for the valuation of a particular asset class, such as under IFRS or with respect to unquoted securities, the basis chosen by the Fund Manager should be communicated to the Commission.

- The basis chosen should be consistently applied. Should there be a need to alter the basis, the change and the reason for the change should be communicated to the Commission.
- Trade date accounting should be adopted as opposed to settlement date accounting.
- Frequency of valuation of assets:
  - For assets traded on a recognized exchange, valuation is to be done daily; for illiquid assets such as securities not traded on an exchange, valuation should be done quarterly.

## 2.7 Pricing

With respect to pricing of units, it is important that a clear distinction is made between closed and open end fund structures particularly in terms of frequency of computation of bid prices.

### 2.7.1 Recommendations

- Pricing for closed end funds should be based on market price quoted on the exchange. However, Fund Managers should provide investors with the quarterly statement of NAV per unit.
- Similar to what operates in the Pension Industry, pricing for open end funds should be done daily.

## 2.8 Performance Evaluation

<sup>10</sup>According to the CFA Institute, performance evaluation involves three aspects:

- Performance measurement – this deals with the calculation of portfolio performance. It measures the relative change in portfolio value solely due to investment related sources.
- Performance attribution – this is the process of analyzing the sources of returns relative to a designated benchmark
- Performance appraisal – this deals with assessing investment skill.

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<sup>10</sup>CFA Institute – Evaluating portfolio performance by "by Jeffery V. Bailey, CFA, Thomas M. Richards, CFA, and David E. Tierney"

### 2.8.1 Performance Measurement

- The Total Rate of Return is recommended by the CFA as the appropriate measure of investors' wealth<sup>11</sup>. This is the measurement of the investors' wealth due to both investment income and capital gains.
- The total rate of return to be computed as:
  - $R_1 = \{(Market\ Value\ of\ portfolio_1 - Cash\ flow\ received/paid\ out\ at\ the\ end\ of\ evaluation\ period) - Market\ Value\ of\ portfolio_0\} / Market\ Value\ of\ portfolio_0$
- <sup>12</sup>The Time Weighted Rate of return (TWR), which reflects the compound rate of growth over a stated evaluation period of one unit of money initially invested in the
- Fund, is the recommended basis for computing the performance of an account/fund over a period.
- **TWR is recommended** because it is unaffected by size and timing of cash flows to and from the account. In most cases, especially with open end funds, the fund manager has no control over the size and timing of external cash flow into or out of the account.
  - This does not apply to funds where the fund manager has control over the size and timing of external cash flow such as private equity funds.
- Application of TWR requires that:
  - the account/fund be valued each time an external cash flow occurs.
  - a set of sub-period returns are computed and linked together in computing the TWR for the evaluation period.

#### **Actions required: Short Term – ≤ 1 year**

- Adopt TWR as basis for measuring performance of CIS.

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<sup>11</sup> CFA Institute - "Acceptance of the total rate of return as the primary measure of investment performance was assured by a seminal study performed in 1968 by the Bank Administration Institute (BAI). "

<sup>12</sup> CFA Institute – Evaluating portfolio performance by "by Jeffery V. Bailey, CFA, Thomas M. Richards, CFA, and David E. Tierney"

- The SEC should have on its website performance evaluation of CIS based on evaluation period such as for one, three and five years.
  - Evaluation period of annualized returns since inception of the CIS to date.

A sample performance metrics sheet is attached as Appendix 1.

### **2.8.2 Performance Attribution**

Basic concept of performance attribution is to compare the performance of the Fund with that of a designated benchmark and the identification and quantification of sources of differential returns.

- Things required for performance attribution:
  - Designated benchmark for asset classes – these should be decided at set up.
  - Policy allocation – strategic asset allocation
  - Benchmark returns
- <sup>13</sup>The CFA offers a format for performance attribution analysis.

#### **Actions required: Short Term – ≤ 1 year**

- To standardize the market benchmarks for different asset classes
  - We recommend the following:
    - Equity – NSE All Share Index
    - Money Market – Av. Yield of 90 day TBill
    - Fixed Income – Av. Yield of 10 Yr FGN Bond
    - Real Estate – Weighted average of Yield of 10 yr FGN Bond (60%) and NSE All share index (40%)
- Funds to establish appropriate benchmarks based on investment objectives
- Funds to establish strategic asset allocation

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<sup>13</sup> CFA Institute – Evaluating portfolio performance by "by Jeffery V. Bailey, CFA, Thomas M. Richards, CFA, and David E. Tierney"

### 2.8.3 Performance Appraisal

- The objective of performance appraisal is to assess the display of investment skill and if this skill will be sustained.
- The CFA defines investment skill as the ability to outperform an appropriate benchmark consistently over time.
- It is the magnitude of the value-added return relative to the variability of the value-added returns that determines a manager's skill.
- Risk adjusted performance appraisal methods are measures that take the volatility of returns into account.
  - 5 different measures are highlighted by the CFA Institute:
    - Ex post Alpha – derived from the capital asset pricing model
    - Treynor measure – relates fund's excess returns to the systematic risk assumed by the fund.
    - Sharpe ratio – relates fund's excess returns to total risk of the fund.
    - M<sup>2</sup> - measures what the account would have returned if it had taken the same total risk as the market index.
    - Information ratio – relates the excess return of the Fund over the benchmark relative to the variability of that excess return i.e. active return/active risk.

#### **Actions required: Short Term – ≤ 1 year**

- Need to standardize an applicable risk adjusted performance appraisal method for the CIS.
  - **We recommend that the Sharpe Ratio be reported as the standard performance appraisal metric for Funds.**
- Fund managers will have the flexibility to adopt other agreed upon measures whilst keeping Sharpe Ratio as a standard in recognition of its wide applicability.
- Both non risk adjusted and risk adjusted returns per annum should be published on the SEC website.

**Action required: Medium Term – ≤ 3 years**

- The SEC should seek to adopt the "Global Investment Performance Standards" (GIPS) of the CFA Institute for the investment management industry. We recognise that this is a complex and potentially costly procedure and may not be feasible in the medium term given that GIPS requires 5 - 10 yrs of retroactive reporting within strict guidelines.
- The GIPS is a set of standardized, industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients.

### **3. Promoting Awareness and Confidence in the CIS Industry**

The recommendations in this section address three principal areas we believe the Unit Trust industry needs to focus on to achieve its objectives of achieving financial inclusion and capital formation:

- Building awareness
- Building confidence in the industry
- Enhancing access and availability

To drive awareness, we propose that the emphasis shifts away from mere marketing campaigns—integral as this is to the overall process—to an overarching strategy built on raising life cycle savings and investment to the deserved level of national consciousness with the active involvement of government at all levels. Simply put, the sheer imperative of developing a national savings base to cater for the future and driving domestic capital formation is far too important to be left to any single industry group and so must be recognized and approached as such.

Clearly, even with necessary awareness, effectiveness in engaging the investment public will depend critically on building confidence in the industry and its oversight. This is where the standards and principles of best practice point towards measures taken in other jurisdictions to assure investors. This imperative is even more pressing in Nigeria given its spotty history of instability even in the formal financial system. In our view, investors must be assured of necessary and effective safeguards to their capital and investment interests even as financial sector and capital market regulators work to harness their capital in ways that promote balanced incentives and overall systemic stability.

In this regard, the goal must go beyond simply implementing new regulatory standards to adopting measures that are effective in three key areas:

- 1) ensuring the desired protections
- 2) communicating this assurance to investors; i.e. measures must be robust and SEEN to be robust;
- 3) creating an easily accessible framework for discerning bona-fide industry operators who are subject to the prescribed regime.

The third plank of this process involves creating channels that promote the accessibility of vehicles designed to achieve this end. In this regard, we propose three key values:

- 1) Efficiency in creating platforms for asset gathering which addresses issues like reach and cost;
- 2) a focus on investor needs which calls for a more systematic approach to creating, managing and marketing financial vehicles and instruments in response to local conditions and idiosyncrasies with due regard given to variety in the market place to meet these needs;
- 3) Greater collaboration between industry and financial market operators and regulators, without which required levels of efficiency, cost management and ultimately, effectiveness cannot be achieved.

In proposing ideas we draw examples from practices and developments in other jurisdictions.

### **3.1 Standards, Principles & Best Practice**

Across different jurisdictions, there is an ongoing push to enshrine principles that provide investors' protection, through robust and transparent governance in the structure and regulations of the funds industry, with the goal of building and sustaining investors' confidence. Overall, best practice dictates a regulatory regime which clearly stipulates the continuous disclosure of material information (in addition to regulatory requirements), and empowers the trustees to act in the interest of fund subscribers.

The increased drive by the regulatory body in India to promote transparency has, among other factors, been cited as being responsible for significant inflows into its fund industry.

#### **3.1.1 Transparency & Disclosure**

Currently, the level of disclosure by collective investment schemes in Nigeria substantially lags those of many developing markets including India. Additional disclosure required in India which are not currently required in Nigeria include:

1. **Statement of portfolio** – this is to be sent to all unit holders or published in a national daily half yearly (within 1 month of the end of the period). It includes a list of securities currently invested in and the market value. This is not currently the practice in Nigeria. This reflects on the level of transparency being encouraged in the mutual fund Industry in India.

[http://www.sebi.gov.in/cms/sebi\\_data/commdocs/mfundsnew\\_p.pdf](http://www.sebi.gov.in/cms/sebi_data/commdocs/mfundsnew_p.pdf) - Rule 59A, pg. 56.

2. **Statement of Additional Disclosure** – this is a separate document to be read in conjunction with the Scheme Information Document (SID) of a mutual fund offer. It contains, amongst others, information on the financial performance of other funds by the sponsor, stating the initial NAV and current NAV, complaints received and redressed, brokerage commission paid to related parties or associates, investment in associates or related parties and transactions with related parties and associates. This level of disclosure is not required in the current regulatory framework in Nigeria. It provides investors with ample information with which to make informed decisions.

### Examples

#### **Reliance Mutual Fund's SAI-**

<http://www.reliancemutual.com/UploadFiles/Downloads/Statement-of-Additional-Information-RMF.aspx>

**Tata Mutual Fund's SAI -** <http://www.tatamutualfund.com/buying-our-funds/pdf/Sai25.pdf>

India recently introduced additional disclosure requirement for mutual funds in the country. Mutual funds and AMC are now required to host a soft copy of each half year unaudited financial results of the fund on their website. The regulation further prescribes a format which is to allow for easy comparability between various funds. Furthermore, the mutual fund and the AMC are to advertise the hosting of such financials in at least one daily newspaper.

Detailed breakdown of annual recurring expenses of funds in India are disclosed on the funds website e.g custodial, investment management and advisory, audit fee and expenses of trustees. In Nigeria such information are usually only available in the initial offer documents – updated information is not easily accessible. Moreover, whilst daily NAV is available, historic data is scarcely available to facilitate comparison.

With regard to disclosure, substance is clearly much more important than form. Despite the risks frequently updating investors about the pricing of their assets pose to sound investment decision making, it is desirable to get investors acquainted with their investments and believe that they have up to date reporting on their performance should they so desire as a way of building confidence and a sense of ownership. Additionally, the availability—and widespread recognition—of vehicles that exhibit different levels of volatility/return profiles should, with appropriate disclosure, lead investors to naturally

gravitate towards instruments that fit their risk profile over time, aided by appropriate education.

### 3.1.2 Fees, Commissions & Expenses

<b>Table 1: REGULATORY CAP FOR EXPENSE RATIO IN INDIA<sup>14</sup></b>		
Funds of Funds		Total expense not to exceed 2.50%
Index Funds		Total expense not to exceed 1.50%
	Other Schemes	Debt Schemes
Up to 100m rupees (\$1.835m)	2.50%	2.25%
On the next 300m rupees (\$5.505m)	2.25%	2.00%
On the next 300m rupees (\$5.505m)	2.00%	1.75%
On the balance	1.75%	1.50%

Source: SEBI (Mutual Funds) Regulations, 1996

<b>PAKISTAN EXPENSE RATIO</b>		
	<b>EXPENSE RATIO</b>	<b>ASSETS</b>
JS ISLAMIC FUND	3.06	2.7089 bn rupees (\$49.69m)
UNIT TRUST OF PAKISTAN	2.54	13.6687bn rupees (\$250.85m)
ASKARI HIGH YEILD	1.77	12.9515 bn rupees (\$237.68m)
JS FUND OF FUNDS	0.88	4.7928 bn rupees (\$87.94m)

Source: Bloomberg.com

Fees and expenses in the mutual funds industry have generally trended lower over the last decade; on average, expense ratios incurred by US investors in long-term funds declined in 2011 to ~ 0.79% for equity funds and 0.62% for bond funds. Similar to this, management expenses are generally trending downwards in Nigeria however, relative to other more developed markets, the 5% cap on total expense ratio is still quite high. When compared to India for example, the cap on total expense ratio is at 2.5% and recent developments in the industry suggest that SEBI may review this cap downwards after its last review which was 2 years ago. Given the importance of lower cost of funds in the decision making process of investors, it is becoming increasingly important for funds in Nigeria to

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<sup>14</sup> Calculation is to be based on average daily or weekly net average value (NAV) (depending on how fund is calculated). Limits exclude issue or redemption expenses. A new regulation is expected to increase the limit to about 3% - Source: The Economic Times – 24/08/2012

lower their costs. The Investment Company Institute (ICI) in its research found that mutual fund shareholders invest predominantly in funds with lower expense ratios.

The investment company institute, in its fact book identified the growth in fund assets over the period as one of the factors driving the decline in fund expenses, given its inverse relationship with fund assets. They also noted that a shift by investors towards no load share – classes which tend to

have lower than average expense ratios accounted for some of the declines in overall fund expenses.

Also, mutual fund expenses have been pushed down by economies of scale and competition within the industry. For example, the number of households owning mutual funds has more than doubled since 1990, going from 23.4 million in 1990 to 52.3 million in 2011. Over the same period, the number of shareholder accounts rose from 61.9 million to more than 275 million. Ordinarily, such a sharp increase in demand raises fund expense ratios. Any such effect, however, was more than offset by the downward pressure on fund expense ratios from competition among existing fund sponsors, the entry of new fund sponsors into the industry, and economies of scale resulting from the growth in fund assets.

In view of the constraints imposed by high costs in a challenging operating environment, we believe that alongside initiatives to grow subscription base and achieve scale economies, efforts to reduce expenses must be anchored around industry-wide initiatives aimed at promoting efficiency via the use of common platform. The key areas are

- **Back office operations:** Alongside the industry, regulators should promote the adoption of a single entity that manages all back office operations of registered fund managers under a common platform and set of standards similar to the CSCS in certain aspects.
- **Joint marketing and distribution:** As we discuss at length in the marketing section, we see significant opportunity for the industry and SEC to create a common platform for promoting the adoption of unit trust structure on the back of overarching initiatives aimed at putting investment and domestic capital formation at the forefront of fiscal policy issues. This way the industry can obtain considerable mileage from government efforts in this regard as well as launching a joint awareness campaign to acquaint would be subscribers of the benefits of using unit trusts as vehicles for achieving life goals.

- The second plank of this initiative lies on creating a regulatory backed assurance system in the marketing effort. This is to be subsumed under a scheme that promotes confidence by providing explicit regulatory recognition and backing to registered managers via creating a common platform to promote their services that is widely recognized and accessible. Explicit and visible regulatory backing and

involvement in such a platform serves as quality assurance which allows investors to immediately discern bona-fide participants whilst promoting peer benchmarking to reward performance akin to the Morningstar investor services.

- **Efficient asset gathering through feeder funds open architecture network:** The SEC can encourage and incentivize the industry to promote the use of common platforms to market funds using each other's platforms based on agreed fee structure to attain the integrated structure of financial industry, evident in more developed markets, which cascades links between the front-end (e.g. insurance and pensions industry that cater to risk sharing and long term savings generation) through to the back-end (asset management and brokerage that intermediate with economy). The weak links between these segments of the financial market, which arise from underdeveloped financial super-structure, impedes capital formation and financial specialisation and is partly responsible for absence of concerted action in promoting savings in the economy by financial sector operators.
- Also related to this factor is the lack of a framework to leverage on economies of scale to address costs in the funds industry. Since a charge differential will exist between private and institutional clients with much large asset bases and greater pricing power, the emergence of a feeder fund structure may be an effective way to address this problem. However, this development will require close collaboration and significant regulatory and institutional support across the financial industry.
- The third plank of this initiative lies in promoting greater diversity in fund offerings to address a wider variety of investor needs and constraints. A more efficient super structure of feeder funds and cross industry links could help promote seamless processing of investment funds and help foster

systemic stability in the financial sector by creating inherent flexibility in responding to changes in the market environment without wholesale capital flight as well as offering regulators a window into accessing changing investor moods.

### **3.2 Governance**

Beyond regulatory and other disclosure requirements, we believe adopting appropriate governance structures is key both to enhancing actual oversight of unit trusts and building investor confidence in this regard. As obtains in other jurisdictions, regulation in Nigeria provides for the assets of the CIS to be vested in trustees where the scheme is constituted as a trust fund. The trustees is responsible for exercising oversight functions over the fund and protecting investors' interest as applicable in other jurisdictions, however, best practice suggest slightly different approach to what is currently in place.

Globally, the financial crises of 2008-09 has led to increased powers for and consequently, greater responsibility and accountability for the trustees of mutual funds. To this end, there has been an increase in the adopting board structure with largely independent members—in India, regulations now require 2/3 independent members (who shall not be associated with the sponsor) as opposed to 1/2 previously. The practice in Nigeria, in which members of the investment committee of the board of trustees are also members of the AMC, contrasts sharply with this trend. Also in jurisdictions such as India, rights and obligations of the trustees as will be included in the trust deed are provided by regulations (like appointment of independent auditors) whereas Nigeria's guidelines where it is largely formulated by the drafters of the trust deed, giving room to restrict their oversight function of the board. In our view, the current system exhibits some significant deviations from best practice:

Investment committee is the only committee available for mutual funds in Nigeria. In the US, the audit committee, consisting of independent directors and external auditor act to monitor the activities of the mutual funds also.

In Nigeria, the trust deed gives the Fund manager the power to appoint trustees, subject to SECs approval but there is no requirement on the independence of the members. In India, at least 2/3 of the members should be independent whilst its 40% in the US. A survey by the Investment Company Institute covering 1996- 2010 shows that independent directors constitute a majority of the board, above 75%. Adoption of such policy in the Nigeria context and awareness of same should improve overall confidence in the administration of the mutual funds.

In the US, Fund advisers cannot fire an independent director of a fund. Also, appointment of new independent directors is made by other independent directors. Furthermore, in continued effort to ensure independence, the independent directors set their own compensation. Such a practice in Nigeria would aid the objectivity of the independent trustees in execution of their duties and should boost overall confidence of investors in the trustees of a fund. In Nigeria Fund managers are able to appoint a new trustee in place of a retiring trustee, subject to SEC's approval.

### **3.3 Risk Management**

The prescriptions under the risk management framework serve a dual purpose of promoting investor confidence as well as encouraging much greater dynamism and efficiency in the management of fund assets.

Over the last couple of years, trends in risk management processes for mutual funds have been changing particularly as regulatory climate in the industry have become increasingly more stringent, for example, the recent implementation of the proxy disclosure rules in the US which requires board of directors to make enhanced disclosures surrounding risk oversight. A survey conducted by PWC for directors of organizations showed that unlike the conventional approach to risk management which tended to focus on investment risk with a clear emphasis on quantifiable risk, the emerging framework takes a more holistic view on the enterprise with a heightened focus on governance and controls. From a broader perspective, the industry regulators (SEC) provide a broader framework for risks which provide guidelines for the board of directors to adhere to for example, the 'Investment Act of 1940' in the US provides a maximum amount of illiquid holdings for the industry which provides a risk management basis for liquidity risk to an extent. As such, with an industry level framework for management of risks, asset management companies will be compelled to adhere to industry standards improving the overall standard of the industry thereby boosting investor confidence.

The FSA recently carried out an analysis of the business conduct of asset management companies and noted that the funds industry is driven by ambitious focus on investment performance as opposed to customers' needs, a built in structure of asset management firms which allows them to avoid clear responsibility in such circumstances – this is becoming an increasing concern. As such the FSA has revised its final guidance document for asset management firms to incorporate measures which enable proper risk profiling and management by fund managers.

However the thrust of risk management need to become more dynamic and incorporate modern concepts in portfolio construction and management. In particular, we believe capacity building especially in the technical aspects of this exercise can substantially raise standards of practice and promote systemic stability in capital markets. It could also help forestall long term potential underperformance that is often engendered by applying heuristic approaches prevalent under the current guidelines, e.g. in the prescriptive limits to asset and/or securities allocation which are often applied based on rules of thumb. We believe industry-wide capacity building in the learning and application of modern portfolio construction and risk management —as well as continuing education to keep on the cutting edge of developments in this area---which will be championed by and also encompass regulators, is the most effective way to overcome this particular shortcoming.

### **3.4 Investor Education**

**Investor awareness:** Several jurisdictions have bridged this important gap by raising investment issues to forefront of national discourse through broad based and concerted campaigns conducted jointly across all segments of the financial industry. Much of the efforts of these campaigns is aimed at addressing post retirement living standards and old-age poverty and have become an effective platform for mustering political action around the issue. Nigeria will likely require a broad based, multipronged campaign, jointly anchored by financial sector regulators, to elevate awareness at a political and consumer level. The SEC is well placed to coordinate these efforts.

Beyond necessary interventions to be elicited from government and other financial industry regulators and players, we believe the industry can obtain greater mileage by pooling resources for sensitization efforts at the industry levels, allowing players to focus only on differentiation. The Securities Exchange Board of India recently came up with a new regulation in a bid to improve overall investor awareness in the mutual funds industry. Mutual funds are now required to set apart a minimum of 2bps on daily net assets within the maximum stipulated total expense ratio for investor education and awareness initiatives of which such initiatives are required to be completely disclosed in the half year trustee reports. This move is expected to have a positive impact on the industry growth by helping drive awareness initiatives at the industry level.

Education efforts should clearly be channeled at helping consumers come to better grips with market realities and also make better informed decisions such as investing in a wider variety of asset classes through promotion and incentives. This helps promote financial system stability by encouraging necessary diversification whilst minimizing occasional crises of confidence that may arise from the collapse of asset bubbles which damages hard won investor confidence collaterally.

Similar to Nigeria's experience, overall investment climate in India appears to be struggling following the 07/08 financial crisis which led to poor returns from the stock market. This was a global phenomenon and we have since seen governments in other economies launch initiatives to stabilize the investment climate. In India for example, to expand investor base and encourage individuals to patronize alternative investments outside Gold which was seen as a safe haven, the government took a decision to provide an incentive for first time investors in top shares in the form of tax-breaks which is expected to boost investment from middle-class segment of the economy.

Trustees should be encouraged to invest in the funds they manage. Whilst there is no known regulatory requirement in other jurisdictions, a survey in the US showed that as at YE 2010, 29% of participating funds have a policy requiring investment by board members in the fund they manage, while 37% encourage same. The generally sense is that investment by trustees (and disclosure of same) in funds that they manage will send positive signals to the investing public.

**Product Development:** Funds in Nigeria can invest in securities listed in S.171 of the ISA and additional securities as prescribed by the commission. Unfortunately, no new security has been developed by the SEC. In India, various broad ranges of products are available including recently, infrastructure funds. In addition, funds are allowed to hedge positions with various derivative instruments.

## **4. Marketing Plan**

### **4.1 Marketing Strategy**

Across the globe, mutual funds have been used as tools to mobilize household savings and promote industrial growth. Countries have increasingly used debt and equity securities rather than bank loans to finance economic expansion. We believe the growth of unit trust Nigeria is central to building a virile capital market to facilitate capital formation needed to stimulate economic growth. We believe the marketing drive should be anchored primarily at getting the government's involvement or support in driving the growth of Unit Trust Scheme's as was the case in India when the government in recognition of the importance of mutual funds in economic development, established in 1964 the Unit Trust of India. The trust was established with the objectives to mobilize household savings and invest in capital markets to drive industrial growth. In India, the government had played the major role in promoting Unit Trust industry, being the major players in the industry till emergence of private sector funds in 1993. The creation of the Unit Trust of India was made possible through the efforts of the Indian Government and the Reserve Bank of India, in 1963 the UTI Act was passed by the Indian parliament. At that time, the primary objectives were to mobilize household savings and investing the funds in the capital market to enhance industrial growth because it was believed the UTI would provide a platform for channeling larger shares of household savings to corporate sector investments. The Reserve Bank of India exercised regulatory control over the UTI till 1978 when regulatory control was transferred to the Industrial Development. We believe the relative (to other developing economies with similar metrics) inclusiveness and sophistication of India's funds industry is directly traceable to this intervention (see Tables 2&3 below).

**Table 2: GDP PER CAPITA**

	2010	2011
<b>Pakistan</b>	1018.87	1194.33
<b>India</b>	1375.39	1488.52
<b>Nigeria</b>	1242.48	1452.09

**Table 3 Countries**

Countries	Access to Bank Accounts	NAV TO GDP 2011
<b>US</b>	92%	77.00%
<b>UK</b>	90%	33.60%
<b>ARGENTINA</b>	30%	1.50%
<b>PAKISTAN</b>	44%	1.40%
<b>PHILIPINES</b>	27%	1.10%
<b>INDIA</b>	30%	4.70%
<b>SOUTH AFRICA</b>	49%	30.60%
<b>NIGERIA</b>	21%	0.20%

With respect to, though we do not advocate the creation of a state run Unit trust investment scheme in Nigeria, this being both unnecessary and anachronistic, we believe the government—and broader financial industry—should be closely involved in promoting awareness of the imperative for building savings, as well as in the establishment laws and a system of incentives to promote growth in the industry.

## 4.2 Marketing Channels and Effectiveness

In order to understand the distribution channel options that are available to the Nigerian mutual fund industry, we surveyed the distribution channels available in other economies with more robust mutual fund industries. five key distribution channels were identified for collective investment schemes in Europe (Finland and United Kingdom), America and Asia (India). The identified channels include:

- Direct channel
- Advice Channel
- Retirement plan channel
- Supermarket channel
- Institutional channel.

The first four channels serve individual investors, while is the fifth is designed for large corporate and institutions.

**Direct channel:** Here investors carry out transactions directly with mutual funds either through the internet, telephone, mails or at customer service centers, it is the mutual fund that is responsible for record keeping, transaction processing and client statement issuance. Also for this channel, the fund sponsor does not provide any investment advice, so investors undertake own research to choose fund.

**Advice channel:** main feature of this channel is the provision of investment guidance, assistance and advice by financial professionals. These include full service brokers, independent financial planners and advisers, registered sales representatives at banks and insurance agents, generally referred to as distributors or underwriters. They help potential holders identify financial goals, assess risk tolerance and assist select mutual funds that meet the identified goals. They act as intermediaries between the fund and investors. Conduct transactions for the fund holders and also keep their record. In return, fund holders compensate these professionals by paying extra fees, above those charged by the funds.

**Retirement plan channel:** Employers sponsoring defined contribution plans engage third party administrators (TPAs) who administer plan and provide planned investments to employees which include mutual funds, company stock and bonds. The TPAs are responsible for all forms of record keeping and understanding employee goals relating to retirement. TPAs are compensated by either the employer, direct charges to employees, or fees included in the mutual fund expenses to be paid by the fund sponsor.

**Supermarket channel:** These are run by discount brokers and its most attractive feature is the non-transaction fee programme, where an investor can purchase mutual funds with no transaction fees from a large number of fund companies. They also provide fund sponsor with access to a national retail distribution channel and provide competition amongst funds as investors can readily compare fund fees, expenses and returns. Similar to the direct channel, supermarkets do not provide investment advice and investors must undertake own research when choosing funds. However they do provide tools to make easier for investors to make investment decisions.

**Institutional channel:** This involves variety of institutions purchasing fund shares for their own accounts. They either purchase from the fund company directly or through third party distributors. For example, banks and other parties that help institutions manage their cash holdings create platforms that permit institutional investors place money in multiple money market funds and to move money between funds on these platforms. The arrangement allows institutional investors diversify their cash holdings across funds.

European and Asian mutual funds predominantly use banks as the major distribution channel with a market share of 53% and 76% respectively. In the US however, only 8% of funds are sold through the banks. The United Kingdom is an anomaly for the European statistics, as only 10% of funds are sold through the banks. In seeking to explain the pattern obtained in Europe, analysts suggest that individuals in Europe appear to value service at least as much as fund performance hence the huge dominance of banks in the distribution chain in that region. They opine that good service levels are important for distribution channels to be effective.

Currently, in Nigeria the distribution of sales of mutual fund units is driven by only the direct and advice (partly) distribution channels, which, in the context of weak financial intermediation and high level of fragmentation amongst key industry players in the financial services sector, may help explain the low penetration, poor customer awareness, and the correspondingly slow overall growth.

In our view therefore, creating interdependent distribution channels for the mutual fund industry is an important step towards accelerating the growth of the industry, with various stakeholders playing different but equally critical roles. Similar to developments in the Indian mutual fund industry we believe initiatives for driving adoption of unit trusts should involve higher level engagement that encompasses government via the ministry of finance, financial service regulators in pensions, insurance, banking, mutual funds etc, capital market regulators and tax authorities etc. The goal would be achieving harmonization in policies and procedures across multiple regulatory frameworks in the financial services sector to foster beneficial interdependence amongst stakeholders and harness resources

(e.g. distribution channels) across the financial services sector towards the common goal of asset gathering along the lines of structures discussed earlier. For example, under such arrangement, it should be possible for a fund manager to be able to sell units of its funds through banks' retail outlets, insurance investment centers vice versa either for a fee or on a quid pro quo basis. Clearly, to foster this level of engagement, fiscal and monetary authorities need to acknowledge the critical role capital formation through the markets for long term savings play in economic growth and the industry must devote substantial energies to achieving high level of awareness of the issues as a prerequisite to any marketing effort.

Closely related to this are initiatives that harmonise roles across industries. E.g. similar to the 401K and IRA systems that obtains in the U.S, we believe the pension industry for instance should be encouraged to develop closer links with the fund management industry as the back end of their efforts, which should help cut out widespread duplication of effort across the Nigerian investment management industry.

## **5 The Roadmap - Critical factors to consider**

- 5.1 Downward review of the time it takes to approve and register collective investment schemes: It currently takes anything from 6-18 months to register and approve a mutual fund. The process involves the drafting of the Trust Deed for the Fund by the solicitors to the Fund Manager, once this has been done it will be forwarded to the Securities and Exchange who will review and recommend amendments, replacements, expunging etc. The document can pass between all parties several times before final approval is given. We suggest that specific requirements and timelines for different phases/stages be outlined in order to ensure a faster and more efficient process. To reduce the approval timeline, we also suggest that the Commission should consider the possibility of introducing standard form trust deeds and custodial agreements for adaptation by new funds.
- 5.2 Sustained awareness campaign for collective investment schemes: A joint awareness campaign championed by both the regulator and operators to educate the market on the advantages of investing and investing through collective investment schemes. For example, both parties can set aside a fund account that will specifically be used to achieve this objective.
- 5.3 Standardisation of valuation and performance measurement as highlighted above.
- 5.4 Fund Managers' Fixed Proprietary Exposure to their Schemes  
The current SEC Rule requiring fund managers to maintain a 10% subscription level for all their mutual funds at all times penalizes the managers for growing their funds. This requirement is not sustainable especially where fund managers have multiple funds and does in fact, operate as a disincentive to expansion and market growth.  
  
In order to help grow the market, we request that the Commission consider removing this Rule.
- 5.5 Central database for KYC documents – Currently, fund managers keep their own KYC records; we recommend the establishment of a central database for all investors in Collective investment schemes. This database will hold a record of all the regulatory documents required from clients before they can invest in a collective investment scheme and all registered fund managers will have access to this data base.
- 5.6 Establishment of a Central Depository/Administrator for Collective Investment Schemes: The establishment of a depository is required because the sector has recorded remarkable growth, volumes are likely to increase with the passage of time and the physical handling of certificates will become more cumbersome and

time consuming. Without automation and immobilization of certificates, the Delivery and Settlement of units and certificates would become unmanageable, not to mention highly risky. The current delivery, settlement and transfer procedures have traditionally been plagued by lengthy delays, risks of damage, loss, forgeries, etc and considerable investment in time and capital.

- 5.7 Gradual reduction of middle men in the investment process- There are currently too many middle men in the process of setting up and investing in a collective investment scheme. Functions are more often than not duplicated leading to bottle-necks, high costs and in-efficiencies. To this end, we suggest a gradual reduction of parties involved in the process either by outright removal or merging of functions.
- 7.8 Clear Tax position on mutual fund investments: Perhaps a mutation of the voluntary contribution model currently employed by the Pension Managers could be considered, whereby, if an investor chooses to invest regularly over a specified period of time, the entire investment plus proceeds will be tax exempt upon redemption. Tax deferrals could also be another route to adopt where contributions are tax-exempt until the investments are redeemed.

ROADMAP:	Efficiency & Cost Control	Marketing & Awareness	Standards & Confidence Building	Access & Availability
<1 Month	<ul style="list-style-type: none"> <li>i) Establish committee to explore areas of cooperation in back office operations</li> <li>ii) Establish committee to review tax issues and incorporate recommendations</li> </ul>	<ul style="list-style-type: none"> <li>i) Set agenda and modalities for engaging with government</li> <li>ii) Set agenda and modalities for engaging with financial sector regulators</li> <li>iii) Urgently develop agenda and engage PENCOM and PFAs to explore avenues of integrating unit trusts in multi-fund structure (along the lines of IRA &amp; 401k in the US)</li> </ul>	<ul style="list-style-type: none"> <li>i) removal of fund manager 10% fixed proprietary exposure to their schemes</li> <li>ii) Exploratory engagement within industry to evaluate standards and practices and determine constraints faced by operators and regulators including listing requirements etc)</li> <li>iii) implement improved valuation and performance evaluation guidelines'</li> <li>(iv) Set out agenda and embark on exploratory engagement with institutional investors to elicit feed back and determine how unit trust industry can better be integrated with their activities and serve their needs</li> </ul>	
<3 Month	<ul style="list-style-type: none"> <li>i) Committee to explore and report on feasibility of establishing 3rd party and/or clearing-house system for fund operations and administration</li> <li>ii) Committee to explore areas of cooperation in establishing feeder fund structure and open architecture distribution platform</li> <li>iii) Formalise liaison with appropriate authorities on incorporating tax recommendations.</li> </ul>	<ul style="list-style-type: none"> <li>i) Formalise rapprochement with PENCOM on unit trust</li> <li>ii) Engage brand/media consultant to devise strategy for marketing efforts. Consultant to delineate industry level and operator driven campaign efforts and areas of collaboration</li> <li>iii) Commission study to determine format and platform for regulator assurance schemes for registered operators</li> </ul>	<ul style="list-style-type: none"> <li>i) Formally commission study on global benchmarking of standards and best practices as applicable to Nigerian situation</li> <li>ii) Formalise engagement with institutional investors unit trust structures and opportunities</li> <li>iii) Commission study on re-evaluating governance and risk management practices; engage within industry to determine needs and explore modalities for capacity building</li> </ul>	<ul style="list-style-type: none"> <li>i) Commission study to explore and determine effectiveness of different distribution channels</li> <li>ii) Exploratory engagement with banking and other financial sector operators mutually beneficial arrangements in distribution channels</li> </ul>
<6 Month	<ul style="list-style-type: none"> <li>i) Where feasible, engage consultants and third party vendors for common platform in back office operations</li> <li>ii) Where necessary engage consultants to facilitate adoption feeder fund structure and open architecture platforms</li> <li>iii) Prepare position paper/ formal recommendation on taxation of CIS</li> </ul>	<ul style="list-style-type: none"> <li>i) Formalise rapprochement with government and financial sector regulators on investment promotion drive</li> <li>ii) Review and adopt strategy for marketing and communication</li> <li>iii) Commission study on investor behaviour and most effective methods for mass education</li> </ul>	<ul style="list-style-type: none"> <li>i) Formalise capacity building efforts in asset allocation and risk management via joint platform for seminar and trainings etc.</li> <li>ii) Commission review of listing and other rules and guidelines to harmonise activities in other areas of effort and make industry more efficient</li> </ul>	<ul style="list-style-type: none"> <li>i) Formalise engagment with banking and other financial sector operators around distribution platform</li> </ul>

<1 year	<ul style="list-style-type: none"> <li>i) Operationalise open architecture distribution platforms</li> <li>ii) liaise with appropriate authorities to pass/amend/restructure appropriate tax codes with regard to CIS</li> </ul>	<ul style="list-style-type: none"> <li>i) Launch joint campaign with government and financial sector regulators on investment promotion drive</li> <li>ii) Roll out ongoing investor education and awareness campaign</li> <li>iii) Roll out regulator assurance programme</li> </ul>	<ul style="list-style-type: none"> <li>i) Begin phased operationalisation of rules and guidelines in order of predetermined urgency and efficacy</li> <li>ii) Roll our media campaign (alongside marketing effort) to communicate investor protections and build investor confidence</li> <li>iii) Harmonise with regulator assurance programme</li> </ul>	<ul style="list-style-type: none"> <li>i) Operationalise platforms and distribution channels determined to be most accessible to investors</li> </ul>
<3 years	<ul style="list-style-type: none"> <li>i) Operationalise common platform for back office integration</li> <li>ii) Operationalise feeder fund structure in collaboration with broader financial sector regulators</li> </ul>	<ul style="list-style-type: none"> <li>i) Reassess and reposition awareness campaign with consumers, government and regulators</li> </ul>	<ul style="list-style-type: none"> <li>i) Begin phased implementation of disclosure and governance and risk management guidelines paced with industry growth and development</li> </ul>	

# Appendix 1

## PERFORMANCE MEASUREMENT





