REPORT

OF

THE

CONSULTATION ON THE FUTURE OF THE UNIT TRUST INDUSTRY IN SRI LANKA

30 July 2001

SECURITIES AND EXCHANGE COMMISSION OF SRI LANKA
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CONSULTATION ON THE FUTURE OF THE UNIT TRUST INDUSTRY IN SRI LANKA

Held on 30th July 2001
at
the Securities & Exchange Commission of Sri Lanka

The Director General of the SEC Dr D C Jayasuriya welcomed the participants from the unit trust industry and trustee banks. He stated that this consultation was organized by the Securities and Exchange Commission (SEC) to enable market participants to propose necessary changes for the advancement of the industry. At present the market sentiments on the development and the survival of the industry are very low - the industry has been heavily depending on the performance of the stock market, which at present is in a very depressed state.

Industry participants were invited by the SEC to formulate a five-year Master Plan on how the industry will organize itself setting out its expected targets along with concrete proposals on how to achieve them. In this connection the industry was requested to focus on the lines of a possibility of a further hike in the interest rates of Government Securities and the possible continuation of the current status in the stock market. The plan must be based on various alternative assumptions.

Since several SEC staff members had attended international conferences where recent trends within the unit trust industry had been considered, the Director general requested them to make some brief presentations.

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Mrs Lasinee Serasinhe, Senior Manager, Corporate Affairs, Governance and Research, stressed on the importance of an effective distribution system or systems in the industry and stated that the primary mover of any industry is a good Distribution System. A Fund Manager could rely on all of the following systems or have a combination of them:

Distribution Systems

- *Direct Marketing:* own sales force, finance houses and their investment centres
- *Intermediaries:* private banks, distribution companies, brokers, and individual agents
- Non-Banking finance companies
- *Others:* Accounting firms and insurance companies

In the context of the regional markets, the largest distribution system in Australia is the Adviser/Broker network. In Malaysia last year, 60% of the sales were garnered through Financial Institutions while sales forces of the funds contributed 19%. In India, though all the above distribution channels are present, the most frequently used are Individual Agents, Brokers, Distribution Companies and Banks. The recent trend in most of the countries in the region is that Distribution Companies and Banks are emerging as the main distribution channels. Hong Kong and India are good examples of this trend.

Mrs Serasinhe emphasised that each Unit Trust should have its own distribution system that is efficient, effective and acceptable to the investors. Whatever be the distribution system adopted it should be sufficiently widespread to derive the full benefits of the products structured through economies of scale and should reach even the small saver to be successful.

Focussing on the Fee Structure, it was noted that the following fees are charged to the Funds: management fees, trustee fees, registration and legal expenses, marketing and publicity expenses, audit fees, custody fees, registration and transfer agents' charges, other operating expenses etc.

Countries such as India, Malaysia, Australia and Hong Kong have prescribed limits on the fees that should be charged.

Some of the limits prescribed in India by regulation are the following:

1. Front-end fee restricted to 6% of NAV
2. Investment and advisory fees restricted to 1% of NAV calculated weekly
3. The annual recurring expenditure restricted to not more than 2½% of NAV for the financial year

Expenditure charged to the fund is limited to the maximum amount prescribed by regulation. Any amount exceeding the maximum is to be met by the Asset Management Company. The trend, however, is to charge reduced fees even less than the prescribed fees.

Mrs Serasinhe quoted another interesting development in Australia, where the Institute of Directors, Australian Shareholders' Association and the Employees Ownership Association, through collaboration, have developed policies to achieve a strong relationship between fund performance and remuneration of Board Members and the senior management.

The importance of valuation of the performance of a Fund was highlighted. The end result of a professional process of investment is valuation. Valuation of the fund should be dependable as this reflects the performance of the fund.

Hence, standardization of valuations is important to facilitate a dependable basis to compare the performance of funds. This is more so as the investment decisions should be based on the performance of the funds.

In most of the regional markets, assets of each scheme are valued on a daily basis and values are released on a daily basis as well. The Unit Trust Association of India has standardized valuation methods, which have been introduced to the industry by the Association and practiced by the industry. Recently these valuation methods have been included in the regulations.

Provisioning for non-performing assets is important and it will be in the interest of the regulator and the industry to introduce standard valuation methods thus creating a dependable valuation model. India has differentiated the assets to the maximum and adapt valuation methods to each type of asset, which are as follows:

- Interest bearing securities
- Commercial paper
- Treasury Bills & Treasury
- Bonds
- Illiquid securities
- Thinly Traded and Non-Traded Securities

Each Asset is identified based on the guidelines issued.

In building up investor trust in the Investment Funds, it is necessary that in addition to the statutory requirements, attention is accorded to on-going disclosures. Whatever the market performance may be, frequent communications addressing the investors covering market trends and investment strategies are important. Mrs Serasinhe pointed out that in the Sri Lankan market the following important disclosures are not made available or not spelt out properly in the Prospectus:

- Risk factors
- Investment objectives and policies

- Investment limitations
- Fundamental attributes of the scheme
- Computation of NAV
- Who can invest
- Redemption and duration of the scheme
- Expenses of the initial issue fees, expenses
- Unit holder’s rights, tax implications
- Per unit statistics under each present scheme
- Annualised returns
- Ratio of recurring expenses to net assets

Among many of the common objectives of the Unit Trust Associations of the region, they focus on promoting high professional standards by conducting certification processes, training and testing programmes for intermediaries and employees and also by giving recommendations on the disclosures to be made e.g. advertising guidelines, corporate governance aspects. The associations conduct studies on various subjects and gives tax proposals relating to the industry. They also engage in investor education and recommends best practices in the areas of sales, advertising, disclosure and transparency.

In summing up the essential features of a healthy industry, Mrs Serasinghe once again mentioned the importance of having an effective distribution system and the continuous communication with clients. An efficient industry will always strive to maintain high professional standards by adopting best practices and making full and fair disclosures. There should be a trained sales force and intermediaries since the business of the industry touches personal wealth of the public. While the Fund Manager should have sufficient flexibility to invest, a good Fund Manager will make losses smaller by timing sales and purchases on the correct time. There should always be a good follow-up service to the fund holders to keep them with the fund. While building confidence of the investor in a fund will take a long time, such confidence could get eroded in no time if the investors are not kept informed.

Mr Benny Tissera, Senior Manager Market Supervision and Inspection, shared his views on the current position of the industry and on the areas that need attention.

Mr Tissera highlighted the following points:

- **Awareness**

Public awareness on the unit trust industry is at a very low level thus affecting the very growth of the industry. Though initially the SEC had launched an awareness campaign, unfortunately there had been no follow up by the industry. Another thought to ponder is whether the industry has identified the correct market segment and whether it has given any thought in reaching the employees nearing retirement age by checking the EPF database or whether it has ever promoted any of its products through retail marketing by selling over the counter.

- **New Products**

It appears very clearly that the unit trust industry in Sri Lanka lacks new products. The Malaysian industry boasts of 5 Close End Funds, 4 Property Funds and 1 Equity Fund, thus affording diversified investment opportunities to its public. Lessons could be drawn from the local banking sector where banks have come up with long term deposit schemes and made links with insurance companies. Therefore fund managers should give serious thought into introducing Close End Funds if it is to compete with the banking sector.

The industry might also be able to benefit from introducing Investment Linked Funds with insurance policies and money market instruments such as Commercial Papers. Another avenue would be to create US Dollar Funds by tapping the market of NRFC account holders.

- **Offshore Investments**

In Hong Kong 95% of the total assets of funds are invested in overseas-domiciled funds with the prior authorisation of the Securities and Futures Commission, and only the balance 5% are invested locally. Despite the existing Exchange Control restrictions, what Sri Lanka needs to look at is how confident we are in investing abroad.

- **Distribution**

Unit Trust industries in most countries including Japan and Malaysia distribute their funds through retail banks since traditionally the public has placed high trust and confidence in banks. The newest trend is where banks are more inclined to buy into Management Company capital.

Internet Investment Funds

The internet will play an important role in the distribution of investment funds in the future. As it is, in November 1999 around 35 securities companies and 3 Investment Trust Management Companies in Japan have promoted the industry through Internet service.

- **Investment Parameters**

In discussing whether new investment parameters should be introduced, Mr Tissera was of the view that serious thought should be given to whether the Fund Managers have succeeded in increasing Fund assets by not merely diversifying investments in the same proportion.

Mr Kithsiri Gunawardane, Senior Manager, Legal, stated that the industry should first accept the situation it is faced with and question itself why 72% of savings in Sri Lanka are mobilised by banks with Rs. 3.5 billion lying in savings deposits earning very low interests and not invested in Unit Trust Funds.

He further stated that Fund Managers should take cognisance of the fact that there is a tremendous opportunity for the unit trust industry to come up with new and successful products. There is a huge and growing untapped market in Sri Lanka i.e. the senior citizen population. Considering the social strata and the culture of our country, the industry could benefit by introducing products that offer high annuity and long-term investment opportunities to this segment.

Mr Gunawardena then spoke on the importance of conducting a Marketing Research to identify the right niche market and raised the question whether the industry had given any serious thought to it. The industry should offer products that are meaningful to the market, taking elements as inflation and economic situation into consideration.

The industry should strive to overcome the current market situation and come up with innovative and accessible investment schemes outside the paradigms. What the industry needs to realise is that it is not a conduit to the Stock Market and hence come up with a Master Plan that is meaningful and beneficial for the development of the industry.

Mr Jeyavarman, President of the Unit Trust Association (UTA), thanked the SEC for affording this opportunity to the UTA to highlight the problems encountered by the Unit Trust Industry.

He pointed out that in over the ten years the Association had been in existence there had been very few changes since its formulation on the Trust Ordinance of 1917. Though in many countries a Management Company is regarded as parallel to a body corporate and a "Unit" is considered parallel to a "Share", the local industry is in the right path by focussing on the concepts of Trust Law. Mr Jayavarman then stated that however it is timely to revisit the Trust Ordinance and make appropriate modifications to uplift the standards of the industry.

A great problem the industry is faced with is the defining of a Unit Trust as a "company" in the Inland Revenue Act for tax purposes. The industry is crippled with the idea of being taxed and this distracts its focus from forming a product that is transparent to the investors. The speaker stressed the importance of changing the Tax Law and that there should be fundamental changes as a whole in the thinking when it comes to Unit Trusts.

However when compared with countries as India where the Management Company and the Trustee are the same, the Sri Lankan structure is very strong as these parties are regarded as two distinct persons and they should remain so. The accounting standards adopted by the industry are aligned with international accounting standards.

In speaking of the regulatory framework in place, Mr Jayavarman stated that there should be modifications made to the Unit Trust Code, SEC Act and the Trust Ordinance to take the industry forward. The industry would also benefit by having a standard format of the contents of an Offer Document ensuring consistency.

If the industry is to cater to different market segments, it will have to form new Trusts, which is a very difficult and time-consuming procedure. Therefore there should be a more practical approach to cater to market needs by affording Fund Managers with the flexibility to come up with different schemes for different needs rather than having to create new Trusts each time.

Another problem encountered is in obtaining the necessary approval for advertisements, which involves a long process of approvals beginning from the Management Company to the Trustee and finally to the SEC. This long-drawn out process defeats the very purpose of an advertisement. Therefore there is a need for greater flexibility to be brought in by delegation of authority at the level of Trustees, who in turn will be answerable to the SEC, which in its supervisory role would guide the Trustees by formulating necessary policies.

On the topic of taxation, Mr Jayavarman stated that what the industry needs is not a tax concession but a fundamental change in the tax structure governing the industry. If Trust Principals are properly recognised, one would realise that Unit Trusts should be exempted from being taxed at all levels. He further stated that the Unit Trust Association was of the opinion that in order to make products more attractive, investors (especially long-term investors) should be given tax deferrals till the time of withdrawal of funds.

The Association has identified the importance of introducing new products to the market, which in its opinion would be much easier by way of Close-Ended Funds as opposed to Open-End Funds. Hence the SEC was requested to make provisions in the Unit Trust Code permitting the setting up of Close-Ended Funds.

The scenario would have been different had the industry started up with Income Funds and not with Equity Funds which did not perform as expected.

One of the main contributing factors for this failure is that the valuation process does not allow investors with short-term gain. In attracting foreign investors, the industry might be able to benefit if they are allowed to invest in fixed income securities subject to Exchange Control restrictions. Long-term investments should be permitted allowing only long-term gains and not short-term gains to be taken out of the country. It was also suggested that management companies should be allowed to invest in foreign markets under a strict regulatory environment.

In promoting unit trusts, it would be opportune to look at the possibilities of fund management companies being floated by banks since the banking sector is equipped with good distributional channels.

Finally Mr Jayavarman stated that in order to build up investor faith in the industry, an independent performance measurement by a third party should be introduced.

Mr Jayavarman later discussed the paper submitted to the SEC highlighting **Proposals or Changes necessary for the advancement of the Unit Trust Industry.** (Please see Annexure)

At the open forum that followed, the Director General invited market participants to discuss what steps should be taken to revive the industry. Following is a summary of the important areas discussed:

1. **Regulation of the market**

   In a response to an inquiry made by the Director General whether the Unit Trust Management Companies are over regulated, it was pointed out that the SEC takes time to approve investments in unquoted securities especially on Commercial Papers and Asset Backed Investments. The SEC stated that it is amenable to allow investments in unquoted securities subject to them being backed by bank guarantees.

   It was also stated that management companies need flexibility when investing outside the investment parameters of the Trust Deed. The management companies would prefer to amend investment limitations in a Trust Deed under a directive of the SEC rather than having to obtain investor approval each time. Another suggestion was to keep specifics to the Trust Deeds and for the Unit Trust Code to operate on a macro basis, thus affording fund managers with the flexibility to introduce new products.

2. **Advertisements**

   The consensus was that the industry itself should regulate and scan advertisements by delegating the authority to Trustees. Any violation of regulations and policies should be referred to the Unit Trust Association and if necessary to the SEC.

3. **New Products**

The need to permit the setting up of Close-Ended funds was reiterated. It was agreed that the industry lacks attractive products and hence products such as Capital Guarantee Funds, Long-Term Pension Funds and Annuities should be introduced.

4. **Public Awareness**

Since public awareness on the industry is very low, the importance of educating the public by conducting an awareness campaign was highlighted.

5. Management Companies showed interest in converging into many other activities such as underwriting, stock broking and not be confined to unit trust management only.

At the end of the Consultation a consensus was reached that the Unit Trust Code should be amended to accommodate necessary changes and a draft Code is to be circulated in the industry by the 15th of August 2001. The industry participants were requested to submit the SEC with a five-year Master Plan by 10th October 2001.

Annexure

UNIT TRUST ASSOCIATION OF SRI LANKA

PROPOSALS OR CHANGES NECESSARY FOR THE ADVANCEMENT OF THE UNIT TRUST INDUSTRY

Reform Area	Action Needed	Pros & Cons
Taxation		
1. Exempt tax on dividends received from UTs in the hands of the unitholders or Defer tax on reinvestment of dividends till redemption ***	Exempt unitholders from tax on dividend received from unit trusts **Incorporate in IR Act** or Income tax liability on the unitholders on dividend reinvestments in units be deferred until the redemption of units **Incorporate in IR Act**	(+) Encourage a flow of funds to the UT industry which can be channeled for the development of the capital market (+) Defer current tax revenue in view of enhanced future revenue from a sustainable level of funds (+) Encourage investors to choose investment over consumption
2. Compulsory Annual Dividend Distribution of 70% of Income ***	Remove the restriction on compulsory annual dividend distribution and treat unit trusts as a pass through investment vehicle **Amend IR Act**	(+) Reinvestment of income in the fund will lead to organic growth of the industry (+) Fund Manager will have flexibility to decide on the frequency & amount of dividend distribution according to the nature of the fund objectives
3. Tax relief for retirement savings in unit trusts ***	Allow investments in retirement saving plans to be tax deductible from annual tax provided withdrawals are not made for a specific period **Incorporate in IR Act**	(+) Encourage investors to choose investment over consumption resulting in growth in UT industry (+) Provide retirees with a wider choice on investment options to suit their risk profile over forced participation in EPF, ETF etc
New ProductDevelopment 4. Commission close-ended funds ***	Permit close ended unit trust funds to be launched **Amend UT Code Sec 1(2)**	(+) Ability to introduce funds with fixed life spans & fund sizes

5. Provide assured returns on close ended funds ***	Enable FMCs to launch products with guaranteed or pre-fixed returns on close-ended unit trusts with objectives & risk profiles which facilitate such features **Licensing of Unit Funds**	(+) Better marketability of products (-) FMC share capital may have to support any shortfall of assured returns (Also refer item 15 below)
6. Minimum initial fund size of Rs 25 million ***	Allow managers to float funds with a minimum public subscription of Rs 25 mln but emphasis on refunding if the minimum subscription is not achieved during initial offer **Licensing of Unit Trust Funds**	(+) Ease the ability to float new products which suit the market needs
Foreign Investment in UTs 7. Inward investment into UTs in Sri Lanka by foreigners ***	Extend the facility to all types of UTs. Currently restricted to growth funds. **Exchange Control Act**	(+) Attract indirect foreign investments to the country (+) Facilitate UT industry growth
8. Outward Investment by UTs in foreign markets ***	Allow local unit trusts to invest in foreign markets **Exchange Control Act** **UT Code** **Trust Deeds**	(+) Provide diversification to local investors (+) Provide flavour of returns commensurate with risk (-) Temporary capital outflow
9. Ownership in UT Fund Management Cos by foreign shareholders ***	Allow foreign shareholders to own upto 100% of local FMCs. **Exchange Control Act**	(+) Infusion of expertise / products (+) Ability to work with stock broking industry which is open upto 100% to foreigners
Unit Trust Code 10. Investment of Deposited Property ***	Include only minimum investment restrictions common to all funds in the code and include investment restrictions to suit the fund objectives in the trust deed **Amend UT Code Sec 9.1**	(+) Flexibility to offer funds with varying objectives & range of risk profiles will be enhanced (-) Unitholder approval will be required to incorporate any changes to the trust deed

11. Expenses chargeable to the fund ***	Include Statutory Levies & Taxes on management fees **Amend UT Code 12.1**	(+) Clarity of expenses chargeable to the fund
12. Definition of Subsidiary/Associate Affiliate for related party transactions **	Remove current restrictions provided it is disclosed to trustees at the time of carrying out the transaction and the trustee to report to the SEC on a monthly basis **Amend UT Code Sec 15.3**	(+) Enhance value addition to the funds
13. Advertisements ***	Allow trustee to approve advertisements within SEC guidelines **Amend UT Code Sec 18.1**	(+) Avoid unnecessary bureaucracy
14. Publication of accounts biannually ***	Send a comprehensive report annually to each unitholder and at least publish half yearly accounts in print media **Amend UT Code 27.1**	(+) Reduce cost of printing & Postage expenses of funds
Fund Management Companies		
15. Minimum share capital requirement of Rs. 25 mln ***	Entry requirement in forming a management company to remain a Rs. 25 mln but review case by case for reduction of capital for reduction below the entry level **Licensing of Management Companies**	(+) Would restrict mushroom companies with no financial backing entering the regulated fund management business (+) Shareholder commitment to continue in the industry re-iterated
16. Broaden activity horizon of management companies ***	Reduce restrictions on asset management related activities **Licensing of Management Companies**	(+) Increase revenue deriving modes of FMCs
Compliance		
17. Unit Trust Fund performance measurement *	Encourage impartial independent fund performance measurement for better credibility	(+) Independent opinions enhance credibility
***** High Priority**	**** Medium Priority**	*** Less Priority**

LIST OF PARTICIPANTS

NAME OF ORGANIZATION/BANK	NAME	DESIGNATION
National Asset Management Ltd	Mr S Jeyavarman	Chief Executive Officer
	Mr P Samarasekera	Fund Manager
Eagle NDB Fund Management Co Ltd	Mr Gehan Rajapakse	General Manager
	Mr Namal Kamalgoda	Snr. Fund Manager
The Unit Trust Management Co Ltd	Mr C Sathkumara	Chief Executive Officer
	Ms R Rajapaksa	Snr. Fund Manager
Commercial Fund Management Co Ltd	Ms I S Jayasinghe	General Manager / Chief Executive Officer
	Mr P Asokan	Snr Manager Investments
Vanik Asset Management Co Ltd	Mr Condrad Dias	Managing Director
Deutsche Bank	Mr Tyrone Hannan	Head - Securities
	Ms Sonali Gunawardena	Officer - Securities
Bank of Ceylon Investments & Subsidiaries Division	Mr L G Abeysirigunawardena	Asst. General Manager
	Ms W K I Kularatne	Chief Manager
Hongkong and Shanghai Bank	Ms Priya Yapa	Trust Administration Officer
Securities and Exchange Commission of Sri Lanka	Dr Dayanath C Jayasuriya	Director General
	Ms Lasinee Seresinhe	Snr. Manager
	Mr Benny P Tissera	Snr. Manager
	Mr Kithsiri Gunawardena	Snr. Manager
	Mr Malik Cader	Snr. Manager
	Ms Ianthie Jayaratne	Snr. Manager
	Ms Sanali Weerasekera	Executive
	Ms Thamari Senanayake	Executive
	Ms Himani Kotagama	Executive
	Ms Chandanika Jayawickrama	Executive
	Ms Dinesha Perera	Audit Officer
	Ms Sharon Perera	Executive Secretary