RESPONSE TO FEEDBACK RECEIVED – CONSULTATION PAPER ON AMENDMENTS TO THE CODE ON COLLECTIVE INVESTMENT SCHEMES

On 24 May 2006, MAS issued a Consultation Paper inviting comments on proposed amendments to the Code on Collective Investment Schemes (the "Code").

The objective of the proposed amendments is to keep pace with the operating environment and evolving international practices for collective investment schemes. The consultation period closed on 22 June 2006 and comments were received from 10 respondents (listed in Annex A). MAS has carefully considered all the comments received and incorporated them in the Code where appropriate. The final investment guidelines on the Single Issuer and Group Limits as well as on Financial Derivatives are attached in Annex B.

MAS thanks all respondents for their views on the proposals in the Consultation Paper. The comments that are of wider interest and MAS' responses are highlighted below:

Proposed Investment Guidelines in the Consultation Paper: Single Issuer and Group Limits

Appendix 1 of the Code on CIS:

2 Single Issuer and Group Limits

2.1 Investments in securities issued by a single issuer should not exceed 10% of the deposited property of the scheme ("single issuer limit"). Further, investments in securities issued by a group of companies (a group of companies is defined as a company, its subsidiaries, fellow subsidiaries and its holding company) should not exceed 20% of the deposited property of the scheme ("single group limit").

2.2 Notwithstanding the "single issuer limit" and "single group limit" set out in paragraph 2.1, investments in any security that is a component of a scheme's reference benchmark may be up to the benchmark weighting of the issuer, with an additional absolute overweight allowance of two percentage points above the benchmark weight. The reference benchmark should be one which is widely accepted and constructed by an independent party.

2.3 Investments in securities issued by and deposits placed with an issuer, as well as securities of that same issuer which have been lent, should be aggregated in computing the single issuer and group limits. If the scheme holds as collateral securities issued by the aforementioned issuer, these should also be included in computing the scheme's exposure to that issuer.

[Note: Paragraphs 2.1-2.3 above are intended to replace the current paragraph 2.1. The current paragraphs 2.2 to 2.5 will remain unchanged except for numbering.]

Public Comment: A respondent suggested that adequate disclosure should be made regarding a scheme's exposure to any single issuer and/or group.

MAS' Response: The Code currently requires that a scheme's top ten holdings be disclosed in its semi-annual and annual reports. We are of the view that this disclosure is adequate.

Public Comment: A respondent suggested that the single issuer and group limits may not be as relevant for fund managers investing on an absolute return or benchmark unconstrained basis. In such cases, disclosing the risk management systems would suffice and fund managers should be given investment discretion in search of higher returns. Alternatively, flexibility could be granted for trustees to approve exposure beyond the proposed single issuer and/or group limits.

MAS' Response: A key feature of collective investment schemes, as enunciated in the International Organisation of Securities Commissions' Principles for CIS, is to provide investors with a diversified exposure to investment opportunities. There is no good basis to remove the single issuer and group limits. MAS recognizes that there is growing interest in absolute return funds that deviate from this diversification principle and will consider the need to introduce a separate appendix in the Code to cater to such funds.

Public comment: A respondent recommended that, with respect to the proposed single issuer and/or group limits, subscription monies received at any point in time, and credited with the custodian bank, pending the commencement of investment by the scheme should be treated as an exception.

MAS' Response: We agree and will amend the Code accordingly.

Public comment: Respondents sought confirmation on whether:

a) The single issuer and group limits include money market instruments issued by the group;
b) The single issuer and group limits include exposure to underlying securities of a financial derivative e.g. If a scheme invests 8% of its deposited property in shares of Company X and also in a covered warrant where the underlying are shares of Company X, which amount to 3% of its deposited property, would the scheme be in violation of the 10% single issuer limit; and
c) The higher single issuer and group limits allowed under paragraph 2.2(a) of Annex 1A of the Code apply to both the counterparty with a minimum credit rating of A and the underlying issuers of securities.

MAS' Response: We confirm that:

a) The single issuer and group limits extend to money market instruments;
b) Exposure to the underlying securities of a financial derivative should be counted towards the single issuer and group limits. Based on the example given, the scheme would have a total exposure of 11% to Company X; hence it would be in violation of the 10% single issuer limit; and
c) The higher single issuer and group limits allowed under paragraph 2.2(a) of Annex 1A of the Code apply to the counterparty only and does not extend to underlying issuers of securities.

With regards to part (b), we have incorporated a new paragraph 2.4 to Appendix 1 of the Code to clarify that exposure to the underlying of a financial derivative has to be included in the calculation of the single issuer and group limits.

Public Comment: Several respondents sought to clarify how investment limits would be calculated for any group of companies.

MAS' Response: The following are scenarios for the application of the proposed single issuer and group limits. We will be incorporating these in Appendix 1 of the Code.

Suppose companies A and B are both subsidiaries of Company X (X and its subsidiaries to be collectively known as a "Group").

(I) Assume that both A and B are not included in the reference benchmark.

A CIS may invest up to 10% of its deposited property in securities issued by A and another 10% of its deposited property in securities issued by B. The CIS may invest up to 20% of its deposited property in securities issued by companies in this Group.

(II) Assume that A and B are included in the reference benchmark with weights of 2% and 5% respectively.

A CIS may invest up to 10% of its deposited property in securities issued by A and another 10% of its deposited property in securities issued by B. The CIS may invest up to 20% of its deposited property in securities issued by this Group.

(III) Assume that A and B are included in the reference benchmark with weights of 2% and 14% respectively.

(a) A CIS may invest up to 16% [14+2] of its deposited property in B. As the total weight of A and B in the benchmark is less than the 20% single group limit, the 20% single group limit applies. Hence, the fund may invest up to 4% in A or any non-reference benchmark securities issued by the Group or a combination thereof.

(b) If the CIS invests, say, up to 2% of its deposited property in securities issued by A and 16% of its deposited property in securities issued by B, it may invest a further 2% of its deposited property in non-reference benchmark securities issued by the Group.

(IV) Assume that A and B are included in the reference benchmark with weights of 12% and 14% respectively.

A CIS may invest up to 14% [12+2] of its deposited property in securities issued by A and another 16% [14+2] of its deposited property in securities issued by B. However, as the single group limit has been reached, no investments in non-reference benchmark securities issued by the Group may be made.

Proposed Investment Guidelines in the Consultation Paper:
Financial Derivatives

Appendix 1 of the Code on CIS:

4 Financial Derivatives

4.1 Adequate risk management procedures and controls should be in place if the scheme invests in financial derivatives for purposes other than hedging existing positions in a portfolio.

4.2 The manager should set out in the prospectus the risk management procedures and controls of the scheme as well as state that these procedures and controls will be in place so long as the scheme invests in financial derivatives as part of its general investment policy.

4.3 Exposure arising from investments in financial derivatives should not exceed 100% of the deposited property of the scheme.

4.4 In calculating exposures arising from investments in financial derivatives, the true and accurate risk of the investments should be reflected. An example of calculating such exposure is by converting the derivative positions into the underlying assets embedded in those derivatives. The method used for determining the scheme's exposure should be disclosed in the prospectus and be subject to an assessment by the manager's in-house risk management expert or an independent expert.

[Note: Paragraphs 4.1-4.4 above are intended to replace the current paragraphs 4.1-4.2.]

Public Comment: Several respondents suggested that MAS provide guidance on (i) what constitutes adequate risk management procedures and controls and (ii) the expected level of disclosure on the risk management procedures and controls.

MAS' Response:
(i) All schemes which make use of financial derivatives should ensure that the risks related to such financial instruments are duly measured, monitored and managed. It is the manager's responsibility to assess the adequacy of *risk management* and *compliance* procedures and controls given the risk profile of the financial derivatives used. Respondents may refer to the framework outlined in MAS' Guidelines On Risk Management Practices for guidance. A link to the guidelines is set out below: http://www.mas.gov.sg/masmcm/bin/pt1Guidelines_on_Risk_Management_Practices.htm

(ii) The requisite level of disclosure would depend on the extent of the risks related to the use of financial derivatives. It is the manager's responsibility to determine the appropriate level of disclosure that would enable investors to assess the adequacy of the *risk management* and *compliance* procedures and controls.

Three fundamental disclosures will be required in the prospectus:

(a) a statement as to whether financial derivatives are used for the purposes of hedging or meeting the investment objective of the scheme or both;

(b) a description of the risk management and compliance procedures and controls adopted; and

(c) a statement that the manager will ensure that the risk management and compliance procedures and controls adopted are adequate and that it has the necessary expertise to control and manage the risks relating to the use of financial derivatives.

We are of the view that, as a matter of good practice and in the interests of investors, the above disclosures should be made regardless whether financial derivatives are used for hedging or otherwise. This is to enable investors to understand the risk control culture of the manager. Accordingly, we have extended the requirement to all schemes that use financial derivatives.

Managers intending to invest in financial derivatives as an asset class will have a three-month grace period to comply with the new guidelines relating to financial derivatives, while those investing in derivatives in accordance with the current guidelines will be given a one-year grace period to comply.

Public Comment: A respondent suggested that it might be sufficient to file the risk management procedures and controls with MAS, without disclosing them in the prospectus. This suggestion arose from concern that changes in the procedures and controls would have to be reflected in the prospectus, which consequently has to be updated.

MAS' Response: Adequate disclosure on the *risk management* and *compliance* systems in the prospectus is important for investors to make informed investment decisions. We are of the view that material changes to risk management systems do not occur so frequently as to require frequent updating of the prospectus.

Public Comment: A respondent sought to clarify if the exposure in financial derivatives for hedging purposes should be included in the calculation proposed in paragraph 4.3 of Appendix 1 of the Code.

MAS' Response: Exposure in financial derivatives for hedging purposes should be included in the calculation.

Public Comment: Several respondents sought confirmation that MAS will accept any methodology in the calculation of derivative exposure as long as the adopted methodology is disclosed in the prospectus and is subject to an assessment by risk management experts. Other respondents requested that MAS provide guidance on the calculation methodology.

MAS' Response: MAS has decided to adopt the example cited in the Consultation Paper as the default method i.e. exposure arising from investments in financial derivatives would be calculated by converting the derivative positions into equivalent positions in the underlying assets embedded in those derivatives.

Other methods for calculating exposure may be allowed subject to prior consent from MAS. When fund managers apply to use other methods, they should describe the proposed method, the rationale for using the method and demonstrate that the method has taken into account the current value of the underlying assets, future market movements, counterparty risks and the time available to liquidate the derivative positions. To facilitate comparison by investors, the prospectus should include a description of the method used and how it differs from the default method.

MONETARY AUTHORITY OF SINGAPORE
22 December 2006

ANNEX A

LIST OF RESPONDENTS

1. Fidelity Investments (Singapore) Ltd.
2. Franklin Templeton Investments
3. Lion Capital Management Ltd.
4. Singapore Exchange Ltd.
5. AXA Life Insurance Singapore Pte. Ltd.

Five respondents requested confidentiality.

ANNEX B

Extracts from Appendix 1 of the Code on CIS

2 Single Issuer and Group Limits

2.1 Investments in securities issued by a single issuer should not exceed 10% of the deposited property of the scheme ("single issuer limit"). Further, investments in securities issued by a group of companies (a group of companies is defined as a company, its subsidiaries, fellow subsidiaries and its holding company) should not exceed 20% of the deposited property of the scheme ("single group limit").

2.2 Notwithstanding the "single issuer limit" and "single group limit" set out in paragraph 2.1, investments in any security that is a component of a scheme's reference benchmark may be up to the benchmark weighting of the issuer, with an additional absolute overweight allowance of two percentage points above the benchmark weight. The reference benchmark should be one which is widely accepted and constructed by an independent party.

2.3 Investments in securities issued by and deposits placed with an issuer, as well as securities of that same issuer which have been lent, should be aggregated in computing the single issuer and group limits. If the scheme holds as collateral securities issued by the aforementioned issuer, these should also be included in computing the scheme's exposure to that issuer.

2.4 Exposure to the underlying of a financial derivative has to be included in the calculation of the single issuer and group limits.

2.5 The single issuer limit of 10% in paragraph 2.1 may be raised to 35% of the deposited property of the scheme where:

a) the issuer is, or the issue is guaranteed by, either a government, government agency, or supranational that has a minimum long-term issuer rating of BBB by Fitch Inc, Baa by Moody's or BBB by Standard and Poor's (including such sub-categories or gradations therein); and

b) except for schemes with a fixed maturity, not more than 20% of the deposited property of the scheme may be invested in any single issue of securities by the same issuer.

2.6 The single issuer limit in paragraphs 2.1 and 2.2 does not apply where:

a) the issuer is, or the issue has the benefit of a guarantee from, either a government, government agency, or supranational that has a minimum long-term issuer rating of AA by Fitch Inc, Aa by Moody's or AA by Standard and Poor's (including such sub-categories or gradations therein); and

b) except for schemes with a fixed maturity, not more than 20% of the deposited property of the scheme may be invested in any single issue of securities by the same issuer.

2.7 Exceptions to the single issuer and group limits are also allowed for **structured products** subject to the criteria set out in Annex 1A.

2.8 For the avoidance of doubt, the single issuer and group limits do not apply to placement of short-term deposits arising from:

a) subscription monies received at any point in time pending the commencement of investment by the scheme;

b) liquidation of investments pending reinvestment; or

c) liquidation of investments prior to the termination or maturity of a scheme, where the placing of these monies with various institutions would not be in the interests of participants.

2.9 Scenarios for the application of the single issuer and group limits are set out in Annex 1B.

2.10 A scheme may not hold more than 10% of any single issue of securities by the same issuer.

4 Financial Derivatives

4.1 Schemes that make use of financial derivatives should ensure that the risks related to such financial instruments are duly measured, monitored and managed.

4.2 The exposure of the scheme to financial derivatives should not exceed 100% of the deposited property of the scheme at any time. Such exposure should be calculated by converting the derivative positions into equivalent positions in the underlying assets embedded in those derivatives. Other methods for calculating exposure may be allowed subject to prior consent from the Authority. In its application, the manager should describe the proposed method, the rationale for using the method and demonstrate that the method has taken into account the current value of the underlying assets, future market movements, counterparty risks and the time available to liquidate the positions.

4.3 The prospectus should include:

(i) a statement as to whether financial derivatives are used for the purposes of hedging or meeting the investment objectives of the scheme or both;

(ii) where the exposure of the scheme to financial derivatives is calculated using a method other than the method suggested in paragraph 4.2, a description of the method used and how it differs from the method suggested in paragraph 4.2.

(iii) a description of the risk management and compliance procedures and controls adopted; and

(iv) a statement that the manager will ensure that the risk management and compliance procedures and controls adopted are adequate and that it has the necessary expertise to control and manage the risks relating to the use of financial derivatives.

4.4 Schemes investing in financial derivatives as an asset class will have to comply with paragraphs 4.2 – 4.3 above by 22 March 2007. Schemes investing in financial derivatives for purposes of hedging or EPM, provided that derivatives are not used to gear the overall portfolio, have to comply with the guidelines in paragraphs 4.2- 4.3 above by 22 December 2007.