

**In case of discrepancies between the French and the English texts, the French text shall prevail**

Luxembourg 17<sup>th</sup> June, 2004

To all credit institutions, professionals of the financial sector, Luxembourg undertakings for collective investment and all parties involved in the operation and supervision of such undertakings

**CSSF Circular 04/146**

**Concerns:** Protection of undertakings for collective investment and their investors against *Late Trading* and *Market Timing* practices

Ladies and Gentlemen,

The purpose of this circular is to protect undertakings for collective investment (UCIs) and their investors against the *Late Trading* and *Market Timing* practices described hereafter.

To that end, it clarifies the protective measures to be adopted by UCIs and certain of their service providers. These measures take into account the particularities of Luxembourg UCIs which are frequently invested and distributed through all time zones and the marketing of which is frequently undertaken by intermediaries subject to the supervision of a foreign authority.

This circular further fixes more general rules of conduct to be complied with by all professionals subject to the supervision of the CSSF.

Finally, it extends the role of the auditor of the UCI, as described in CSSF Circular 02/81, as regards the verification of the procedures and controls established by the UCI to protect the UCI against *Late Trading* and *Market Timing* practices.

***Late Trading*** is to be understood as the acceptance of a subscription, conversion or redemption order after the time limit fixed for accepting orders (*cut-off time*) on the relevant day and the execution of such order at the price based on the net asset value (NAV) applicable to such same day.

Through *Late Trading*, an investor may take advantage of being aware of events or information published after the cut-off time, but which events or information are not yet reflected in the price which will be applied to such investor. This investor is therefore privileged compared to the other investors who have complied with the official cut-off time. The advantage of this practice to the investor is increased even more if he is able to combine *Late Trading* with *Market Timing*.

The *Late Trading* practice is not acceptable as it violates the provisions of the prospectuses of the UCIs which provide that an order received after the cut-off time is dealt with at a price based on the next applicable NAV.

The acceptance of an order is not to be considered as a *Late Trading* transaction, where the intermediary in charge of the marketing of the UCI transmits to the transfer agent of the UCI after the official cut-off time to still be dealt with at the NAV applicable on such day, if such order has effectively been issued by the investor before the cut-off time. To limit the risk of abuse, the transfer agent of the UCI must ensure that such order is transmitted to him within a reasonable timeframe.

The acceptance of an order dealt with or corrected after the cut-off time by applying the NAV applicable on such day is also not to be considered as a *Late Trading* transaction, if such order has effectively been issued by the investor before the cut-off time.

***Market Timing*** is to be understood as an arbitrage method through which an investor systematically subscribes and redeems or converts units or shares of the same UCI within a short time period, by taking advantage of time differences and/or imperfections or deficiencies in the method of determination of the NAV of the UCI.

Opportunities arise for the *market timer* either if the NAV of the UCI is calculated on the basis of market prices which are no longer up to date (stale prices) or if the UCI is already calculating the NAV when it is still possible to issue orders.

The *Market Timing* practice is not acceptable as it may affect the performance of the UCI through an increase of the costs and/or entail a dilution of the profit.

As *Late Trading* and *Market Timing* practices are likely to affect the performance of the UCI and are likely to harm investors, the preventive measures recommended hereafter have to be applied with great care.

**I. Prevention of Late Trading and Market Timing practices**

*a) protective measures to be adopted by the UCI and by certain of its service providers*

The investor must, in principle, subscribe, redeem or convert the units or shares of a UCI at an unknown NAV. This implies that the cut-off time must be fixed in a manner to precede or to be simultaneous to the moment when the NAV, on which the applicable price is based ("*forward pricing*"), is calculated. A non-precise cut-off time such as, for example, "until the close of business" is to be avoided. The prospectus must specifically mention that subscriptions, redemptions and conversions are dealt with at an unknown NAV and must indicate the cut-off time.

The transfer agent of the UCI shall ensure that subscription, redemption and conversion orders are received before the cut-off time as set forth in the UCI's prospectus in order to process them at the price based on the NAV applicable on that day. In respect of orders received after such cut-off time, the transfer agent applies the price based on the next applicable NAV. The transfer agent shall ensure that he receives within a reasonable time period the orders which have effectively been issued by investors before the cut-off time but which have been forwarded to the transfer agent by intermediaries in charge of the marketing of the UCI after such time limit only.

In order to be able to ensure the compliance with the cut-off time, the transfer agent of the UCI must adopt appropriate procedures and undertake to perform the necessary controls. The transfer agent undertakes either to provide the UCI on an annual basis with a confirmation from its auditor on its compliance with the cut-off time or to authorise the auditor of the UCI to perform its own controls on the compliance of the cut-off time.

If intermediaries in charge of the marketing of the UCI have been appointed by the UCI to ensure the collection of orders and the control of the cut-off time with regard to the acceptance of the orders, the UCI shall ensure that it obtains from each intermediary concerned a contractual undertaking pursuant to which the intermediaries undertake towards the UCI to transmit to the transfer agent of the UCI, for the processing at the NAV applicable on such day, only such orders which it has received before such cut-off time.

The cut-off time, the time at which the securities prices which are taken into account for the calculation of the NAV are fixed and the time at which the NAV is calculated must be combined in a manner so as to minimise any arbitrage possibilities arising

from time differences and/or imperfections/deficiencies in the method of determination of the NAV of the UCI.

UCIs which, due to their structure, are exposed to *Market Timing* practices must put in place adequate measures of protection and/or control to prevent and avoid such practices. The introduction of appropriate subscription, redemption and conversion charges, an increased monitoring of dealing transactions and the valuation of the portfolio securities at "fair value" may constitute possible solutions for such UCIs.

The board of directors of the UCI analyses such solutions with care and will implement them or make certain that they are implemented.

The UCI shall ensure not to permit transactions which it knows to be, or it has reasons to believe to be, related to *Market Timing* and uses its best available means to avoid such practices.

If there exist formal contractual relationships between the UCI and intermediaries in charge of its marketing, the UCI shall ensure to obtain from the intermediary concerned a contractual undertaking from the intermediary not to permit transactions which the intermediary knows to be, or has reasons to believe to be, related to *Market timing*.

The prospectus of the UCIs concerned must include a statement indicating that the UCI does not permit practices related to *Market Timing* and that the UCI reserves the right to reject subscription and conversion orders from an investor who the UCI suspects of using such practices and to take, if appropriate, the necessary measures to protect the other investors of the UCI.

Particular attention has to be paid to subscription, conversion or redemption orders from employees of the service providers acting for the UCI or from any person who holds or is likely to hold privileged information (e.g.: knowledge on the exact composition of the portfolio of the UCI ... etc). Accordingly, adequate measures have to be taken by the service providers of the UCIs to avoid the risk that any such person can take advantage of his privileged situation either directly or through another person.

b) *rules of conduct to be followed by all professionals subject to the supervision of the CSSF*

The CSSF prohibits any express or tacit agreement which permits certain investors to undertake *Late Trading* or *Market Timing* practices.

The CSSF requires that any professional subject to its supervision refrains from using *Late Trading* or *Market Timing* practices when investing in a UCI or from processing a subscription or conversion order of units or shares of a UCI which he knows to be, or he has reasons to believe to be, related to *Late Trading* or *Market Timing*.

The CSSF requires that any professional subject to its supervision that detects or is aware of a case of *Late Trading* or *Market Timing*, informs as soon as possible the CSSF by providing to the latter the necessary information to enable it to make a judgement on the situation.

## **II. Protection of the UCI and investors in case of the occurrence of *Late Trading* and/or *Market Timing* transactions**

Any person who is guilty of knowingly undertaking or supporting *Late Trading* or *Market Timing* practices as defined by this circular exposes himself to sanctions or, in addition, to the obligation of repairing the damage caused to the UCI.

## **III. Additional provisions to CSSF Circular 02/81 on the guidelines concerning the task of the auditors of UCIs**

The auditor of the UCI checks the procedures and controls put in place by the UCI so as to protect itself from *Late Trading* practices and describes these in its long form report. For UCIs which, due to their structure, are likely to be subject to *Market Timing* practices, the auditor checks the measures and/or controls put in place by the UCI to protect itself by the best possible means against such practices and describes such measures and/or controls in its long form report.

If the auditor of the UCI, during the performance of its duties, becomes aware of a case of *Late Trading* or *Market Timing*, he must indicate it in its long form report.

In case of indemnification of investors harmed by *Late Trading* or *Market Timing* practices during the accounting year, the auditor must give, in the long form report, its opinion whether investors have been adequately indemnified.

Yours sincerely,

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

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