Analysis of new CMA guidelines to Collective Investments Schemes, & Cytonn Weekly #41/2020

Focus of the Week

The Capital Markets Authority (CMA) recently published guidelines to Collective Investments Schemes, (CIS), on the valuation, performance measurement and reporting by Fund Managers, highlighting that the guidelines would ensure the standardization of the sector as well as ensure the consistency of the information presented across the sector. The guidelines are a commendable move by the CMA as they will ensure the alignment of the market players and ease comparability across various players. However, they present various shortcomings such as: can the regulator determine the asset allocation for managers? And, do these guidelines override the fund managers trust deed? With this in mind, we found it necessary to demystify these guidelines and give our view on what they mean to fund managers and the CIS industry in general. In this week's topical, we shall delve into the guidelines with a focus on the below;

i. Governance of CIS and where the guidelines fit in,
ii. CMA Guidelines to CIS on the valuation, performance and reporting by Fund Managers,
iii. Impact and Emerging Issues in the sector,
iv. Recommendations on the improvement of the Capital Markets, and,
v. Conclusion and our view going forward,

Section I: Governance of CIS and where the guidelines fit in

Collective Investment Schemes (CIS) are pools of funds that are managed on behalf of investors by fund managers. The amounts invested in the CIS are pooled and utilized by fund managers to buy stocks, bonds or other securities that are in accordance with the funds' objective, with the aim of generating returns for their investors. In Kenya, Collective Investments Schemes are governed by the Capital Markets Authority (CMA) and are regulated under the Capital Markets Collective Investments Schemes Regulations, 2001. The governance structure of CIS' is such that there are checks and balances to ensure investors' capital and returns are protected. According to the regulations, to ensure the proper running of a CIS, it should have a Fund Manager, a Trustee; as well as a Custodian. The Fund Manager administers, manages and ensures that the funds from their investors are invested in accordance with the fund investment objective. A custodian is a company, usually a bank, approved by the Authority to hold in safe custody the funds/ assets of a collective investment scheme. Trustees on the other hand, ensure that the investors' interests are protected at all times.

According to the CMA, these guidelines will be read together with the Collective Investments Schemes Regulations, 2001 and as such, we believe that these guidelines will provide a comprehensive guidance to fund managers on the effective management of investors' funds.

Section II: CMA Guidelines to CIS on the Valuation, Performance and Reporting by Fund Managers

The guidelines, which will be effective 1st January 2021, are meant to encourage international best practice in the capital markets through standardization, thereby enhancing the comparability and consistency of the information presented across the sector. The same policies will indicate how performance is calculated, measured and presented, aside from identifying the methodology to be used for valuing each asset type. The guidelines touch on the operation of CIS, performance reporting, advertisement guidelines and returns calculation for the CIS among others.

a. CIS Operations

Fund Managers are required to establish comprehensive and documented investments policy procedures that will govern the valuation of assets held in the CIS. The policy procedure which will be used to value each type of asset, should be consistent across all the funds managed by the Fund Manager. In the establishment of various funds, fund managers shall be guided by the following criteria:

i. Money Market Funds – The fund shall invest only in interest bearing assets such as Fixed Deposits, Government Securities, Credit Rated Private Commercial Papers / Approved Public Commercial Papers, etc. with a maximum weighted average tenor of 13 months,
ii. Equity Fund - The fund shall invest a minimum of 60.0% of the Assets under Management (AUM) in the equities market. Funds not invested in the equities market shall be invested in cash and cash equivalents,
iii. Balanced Fund - The fund shall maintain a maximum exposure of 60.0% of the AUM in the investments done in the Money Market, Fixed Income and Equities asset classes. Additionally, the maximum exposure in any other asset class shall comply with the limits provided under Regulation 78 of the Capital Markets Regulations, 2001,
iv. Fixed Income Fund - The fund shall invest a minimum of 60.0% of the AUM in fixed income securities, and,
v. Special Funds – The funds shall invest based on the Fund Managers' investments strategy.

Key to note, the investments limits provided in Part VII / Regulation 78 of the CIS Regulations, 2001, specifically are not fund specific, however they limit the maximum investments exposure as below;

1. Securities listed on a securities exchange in Kenya – 80.0%,
2. Securities issued by the Government of Kenya – 80.0%,
3. Other Collective Investments Schemes – 25.0%,
4. Immovable Property – 25.0%,
5. Any other security not listed on a securities exchange in Kenya – 25.0%, and,
6. Off-shore Investments – 10.0%.

Consequently, the recently released guidelines have to be read together with the existing Regulation 78 and also likely inconsistent with fund specific constitutive documents, and may lead to confusion with regard to investment limits given there are now 3 different places to look.

b. CIS Performance Reporting, Calculation and Valuation

Fund Managers shall be required to prepare and submit their performance reports to CMA quarterly and the report shall be submitted within 21 days after the end of each quarter. Additionally, the report shall be made available to the fund managers existing and prospective clients. When determining the total AUM, the fund manager will consider the aggregate fair value of the assets and ensure that the assets have not been double counted. According to the guidelines, should a fund manager choose to benchmark the fund's returns, the report shall be inclusive of the description of the benchmark for instance its name and features. Additionally, the benchmark used shall be of the same type of return, same currency as the fund and the same period for which the returns have been reported. To put it to perspective, for instance, if the fund manager is reporting the performance of the Equity Fund portfolio, the benchmark used may either be the NASI, NSE 20 or NSE 25. In this case, given that Equity Funds primarily invests in the Equities Market, the benchmark used cannot be in the Fixed Income market such as the short term government papers given the variance in the returns and the investments made.

The fund manager’s portfolios will be valued daily and in accordance with the definition of fair value under International Financial Reporting Standards (IFRS 13). IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). In terms of the funds returns, the returns will be calculated using the time weighted rate of return method.

Current Provision: The CIS regulations, 2001, provide that the Net Asset Value (NAV) of the fund shall be calculated by the fund manager at the end of each business day and that the formula to be adopted during the determination of the NAV will be dividing the value of the assets of the fund less its liabilities (including such provisions and allowances for contingencies as the fund manager may think appropriate) by the number of shares issued and fully paid. The regulations also provide that the fund manager’s trust deed shall also include the specific method used for the calculations of the value of the unit trust.

c. Advertisement

When publishing the returns of the fund in any advertisement platform, fund managers will be required to include at a minimum, the Net Asset Value of the fund, the yield in terms of Year to Date (YTD), Month to date (MTD) as well as Quarter to Date (QTD). Net Asset Value refers to the net value of an asset minus the value of the liabilities. Additionally, for all publications, the fund manager shall present the total returns according to at least one, three and five year annualized returns through the most recent period.

d. Disclosure

The guidelines stipulate that the fund manager will be required to list all the funds offered inclusive of the summary of the description of the funds in its website or any other platform that is easily accessible to the funds current and future investors.

Section III: Impact and Emerging Issues in the sector

These new guidelines raise substantive issues with the law and present various shortcomings as set out below:

i. Do these guidelines override the fund managers' trust deed? – The Guidance by the Authority state that Money Market Funds invests only in interest earning assets that have a maximum weighted average tenor of 13 months. The Guidelines however do not address the options available to such schemes given this change impacts the investment strategy of the fund, which is a fundamental attribute of the fund. We note that typically, regulators across the world usually guide Fund Managers on the next steps including a change of name, transition timelines, amendment of the scheme documents as per the CIS Regulations or an option for investors to exit or transition; in this case, the new guidelines leave it vague as to what happens next,
ii. The guidelines have not dealt with the issue as to what happens with existing investment contracts that run for longer periods of time. Thomas Hobbes once noted that ‘before the law, there is no transgression of the law’. This common law principle is interpreted to mean that, the law in most circumstances cannot be applied retrospectively. A newly passed law cannot invalidate a practice that was considered legal prior to its enactment. A law by its nature seeks to provide clarity and not confusion. The provision by the Authority of a transition period and guidance on funds that may not have achieved the criteria set by the commencement date because of investments made prior to the publication of the Guidelines would have been in order. In deed laws in general, have a Savings and Transition Clause to deal with matters in the interim, and,

iii. Regulation 17 (1) Requires Investments according to “provisions of the incorporation documents, the information memorandum, the rules of the collection investment scheme…” It is not clear what happens where the incorporation documents required by Regulation 17 (1) are inconsistent with the Guidelines.

On the upside, these guidelines;

i. Will enhance the accountability and transparency in the reporting of the performance of Collective Investments Schemes,
ii. Will boost investor confidence,
iii. Given the standardization in the reporting of the funds returns, investors will be able to easily compare between the various funds and make an informed decision regarding their investments,
iv. Risk supervision by the authority will also be made easier given that the guidelines promote transparency in the Capital Markets, and,
v. The Guidelines have given Specialized Funds the flexibility to “invest based on the Fund Managers’ investments strategy”, which will allow for innovative structures.

However despite the potential upsides;

i. The guidelines provide the fund managers with a short notice to align their portfolios given that they will be effective 1st January 2021. This short notice will see fund managers incur losses in their portfolio given the increased trading activities in the current volatile market. For instance, a fund manager whose Balanced Fund portfolio has equity stocks above the 60.0% maximum exposure and decides to sell 5,000 KCB shares which had been purchased on 2nd January 2020 at Kshs 54.3, will incur losses of Kshs 16.3 per share should the manager sell the shares today at Kshs 38.0,
ii. The guidelines stipulate that Money Market Funds should only invest in interest bearing assets with a maximum weighted average tenor of 13 months. We believe that capping the maximum weighted average tenor to 13 months will see MMFs invest in assets that offer relatively lower returns such as the 364-day paper, which is currently trading at 7.8%. This effectively locks out potential Money Market Investors who wish to pursue yield generation. Consequently, the returns offered by Money Market Funds will have marginal differences with the bank deposit rates and therefore lose their competitive edge in the market. Over the years, Money Market Funds have gained popularity among Kenyans given the high rate of returns they offer, which has continuously outperformed the bank deposit rates. In Q1’2020, Money Market Funds had an industrial average of 8.7%, 1.7% points above the 7.0% Central Bank deposit rate. In our view, the Authority should have provided for two categories of Money Market Funds (1) Short term money market fund - hold high quality short term money market instruments that are highly liquid; and (2) Standard money market fund – hold quality money market instruments that are highly liquid but have a longer portfolio maturity than a short term money market fund. This would then address the various investment objectives of different investors and is in line with other jurisdictions such as Australia that have adopted the same,
iii. It is not clear how the compliant and non-compliant fund managers will be distinguished by the public. We believe the Regulator’s intention is to ensure investors invest in funds that adhere to their various investment strategies so the naming of the funds can be used as a tool by investors to identify funds they would like to invest in. As such, we believe that there is need for capacity building around the global standards such as the Global Investments Performance Standards.

Section IV: Recommendations on the Improvement of the Capital Markets

In light of the above shortcomings, we recommend the following;

i. Provision of clarity on what happens with existing investment contracts that run for longer periods of time. It is not clear whether these guidelines will affect the existing investments contacts that have a tenor above the recommended 13 months or whether they will only affect new investments contracts done on 1st January 2021 going forward. We believe that the application of these new guidelines to past circumstances that were previously legal would have a negative effect to previous contracts, and as such the guidelines should only affect contracts made after 1st January 2021. In any event, CMA needs to come out clearly and state what happens to existing contracts,

ii. Allow for different forms of money market funds. Additionally, to ensure investors continue to earn above average returns, the authority should consider allowing Fund Managers offer a Standard and a Short Term Money Market Fund which can cater to investors pursuing both liquidity, capital preservation and high returns,

iii. Improve the disclosures for unit trust investors by requiring the fund managers to publish reports that indicate specifically where the funds have been invested. Q3'2020 saw investors in Amana Capital, whose funds had been frozen for the past 2 years, receive a 59.0% impairment on their investments following the losses incurred from investing in the Nakumatt commercial paper. Section 3.2 of the guidelines only require the fund manager to report performance-related information on the general areas of investment for the fund and as such, investors will not be able to specifically identify where their funds are invested. This is a big shortcoming of the Guidelines,

iv. Allow for sector funds: The current capital markets regulations require that funds must diversify. Consequently, one has to seek special dispensation in form sector funds such as a financial services funds, a technology fund or a real estate UTF fund. Regulations allowing unit holders to invest in sector funds would expand the scope of unit holders interested in investing, and,

v. Reduce the minimum investments to reasonable amounts: Sector funds, in addition to cumbersome incorporate as mentioned above, have high minimums of Kshs 1,000,000, which is way above the median wage of Kshs 50,000. Having sector funds minimum that is 20 times the national income seems unreasonably high.

Conclusion

The robust governance structure put in place by the authority, inclusive of these guidelines, will ensure that Kenya's Capital Market more so the Collective Investments schemes are managed well and in a legal and regulatory framework thereby ensuring investor protection and a financially stable system. Additionally, the standardization in the CIS will make it easier for investors to evaluate the performance the funds and compare between the different fund managers. However, we believe that CMA needs to offer clarity to the fund managers on what happens to existing contracts that run for a long period than the recommended tenor. Given that the guidelines take effect on 1st January 2021, we believe that this clarity will go a long way in ensuring a stable financial market without destabilizing the returns offered by the funds more so Money Market Funds. The Collective Investments Schemes Regulations, 2001 indicates that provisions done in the Trust deed relating to unit trusts should be consistent with any provision in the regulations as well as in the Capital Markets Act. Therefore, given that the new guidelines should be read together with the Collective Investments Schemes Regulations, 2001, we believe that fund managers will need to align their trust deeds and other incorporation documents with these new guidelines, but keeping in mind that some changes in the trust deeds may require approval of unit holders.