

FSC Standard No. 8



Scheme Pricing

October 2006

Main features of this Standard are:

- **The principles to be adopted in the calculation of Scheme prices;**
- **Guidance in relation to the application and interpretation of the above principles;**
- **Specification of the practices, procedures and terminologies required to standardise the pricing of Scheme interests.**

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1 Title

1.1 This Standard may be cited as FSC Standard No. 8 “Scheme Pricing”.

2 Standards and Commentary

2.1 The requirements set out in this Standard are shown in bold print. Commentary is shown in normal print immediately after the requirement to which it relates, as an aid to interpretation of the requirement.

3 Date of Issue

3.1 Originally issued 19 July 1999, updated June 2001, June 2002, February 2004 and October 2006.

4 Effective Date

4.1 This Standard must be applied in relation to Scheme prices first determined on or after 1 July 2007. Earlier application of this Standard is permitted and encouraged.

5 Application

5.1 This Standard must be applied by the Operator of a Scheme (“Scheme Operator”) (whether offered for public subscription or otherwise) in determining the price at which transactions in Scheme interests by Investors may take place except:

- where the Scheme interests are quoted on the Australian Stock Exchange;
- where the Scheme Operator has obtained, in relation to the prices at which transactions by Investors in interests in a particular Scheme take place, an exemption from, or been granted relief under, the applicable legislation; and
- where the prices at which interests in a Scheme are transacted do not affect the interests of other Investors (other than as provided by law).

5.1.1 Where Scheme interests are quoted on the Australian Stock Exchange, Scheme prices applicable to transactions in interests of the Scheme (including the issue of further interests) are largely determined by the market rather than by the Scheme Operator. This Standard does not therefore apply to listed Schemes.

5.1.2 Where a Scheme Operator has obtained an exemption from, or been granted relief from the applicable legislation relating to the prices at which interests in a Scheme may be transacted, the requirements of this Standard should be modified accordingly.

5.1.3 This Standard is primarily intended to apply to a Scheme where Investors' money is pooled so that each Investor has a proportionate interest in the Scheme Assets. If the property of each Investor is distinct, the price at which an interest is

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issued or realised does not affect the interests of the other Investors, and this Standard does not therefore apply.

5.1.4 While a transaction in an interest in a Scheme is usually between the Investor and a representative of the Scheme (such as a Responsible Entity or a Trustee), an Investor may also complete a transaction directly with the Scheme's Operator. Where required by law, this Standard applies to the determination of Scheme prices in relation to a transaction between a Scheme Operator and an Investor, and between a Scheme Operator and other Investors although the price applied to such transactions does not affect the interests of other Investors.

5.2 Where an FSC Member's Scheme invests in a Scheme managed by an Associate, the requirements in this Standard apply, except:

- **where the Scheme managed by the Associate of the FSC Member is subject to the laws, regulations, and generally accepted Scheme pricing practices of another country;**
- **or where the FSC Member is unable to influence the process of determination of Scheme prices.**

5.2.1 Where a Scheme invests in a Scheme managed by an Associate of an FSC Member it is clearly in the best interests of Investors to ensure that appropriate Scheme pricing standards are maintained in both Schemes.

5.2.2 FSC Members must, to the best of their ability, ensure that an Associate complies with the requirements described in this Standard.

5.3 Where there is a conflict between the requirements of this Standard, applicable legislation, and the Constituent Document of a Scheme, the requirements of this Standard must, having regard to the purpose of this Standard, be modified appropriately. Any Scheme created on or after the Effective Date must comply with this Standard unless such compliance would conflict with applicable legislation, or the FSC Member's interpretation of that legislation.

5.3.1 It is recognised that the Constituent Document of each Scheme will, while complying with applicable legislation, vary. Where a requirement of this Standard cannot be met (because to comply would conflict with the applicable legislation, the FSC Member's interpretation of that legislation, or with the Constituent Document of a Scheme) a Scheme Operator must, as far as practicable, comply with the requirements of this Standard.

5.4 This Standard may not cover every situation faced by an FSC Member in Scheme Pricing. Where a situation is not covered, an FSC Member must have regard to the intent of the Standard as described in the Statement of Purpose and the Principles of Scheme Pricing.

5.4.1 Where a Scheme invests in a Scheme managed by an Associate of an FSC Member it is clearly in the best interests of Investors to ensure that appropriate standards are applied to Scheme Pricing.

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6 Statement of Purpose

6.1 The purpose of this Standard is:

- to specify the principles to be adopted in the calculation of Scheme prices at which the transaction of an interest in a Scheme may take place, or an interest in the Scheme be valued;
- to provide guidance in the interpretation and application of those principles; and
- to standardise the practices and procedures, and terminology, relating to the pricing of Scheme interests.

This Standard has been designed with reference to the Joint ASIC and APRA Unit Pricing Guide to Good Practice issued November 2005.

- 6.1.1 An Investor valuing his/her investment in a Scheme requires the Scheme price to be provided by the Scheme Operator to determine the investment value.
- 6.1.2 The valuation of the Scheme assets and liabilities is the key element in the determination of the price of an interest in a Scheme. The principles, practices and procedures to be adopted by Scheme Operators to ascertain the value of Scheme assets and liabilities are described in FSC Standard No. 9 'Valuation of Scheme Assets and Liabilities'.
- 6.1.3 This Standard covers the determination of Scheme prices following a valuation of Scheme assets and liabilities determined in accordance with FSC Standard No. 9 'Valuation of Scheme Assets and Liabilities'.
- 6.1.4 For historical reasons, combined with the requirement to hold a meeting of Investors (often at Investors' expense) to approve changes to the Constituent Documents of a Scheme, there are, within the industry, a number of variations in practices and procedures used to determine Scheme prices.
- 6.1.5 It is desirable that there should be an industry-wide standard surrounding the pricing of Scheme interests which is consistent, fair to incoming, outgoing and continuing Investors, and which enables Investors and others to calculate the investment performance of a Scheme over different periods, and to compare that performance with that of other Schemes and investment opportunities. In particular, subparagraph 601FC(1)(d) of the Corporations Act 2001 requires a Responsible Entity of a registered managed investment Scheme to treat members in the same class equally and members of different classes fairly.
- 6.1.6 This Standard may not, however, cover every situation faced by FSC Members in pricing an interest in a Scheme. Where a situation is not covered, an FSC Member should have regard to the intent of this Standard as described in the Statement of Purpose.
- 6.2 Where an FSC Member is, in relation to a Scheme, able to vary the Constituent Document of a Scheme without material additional cost to Investors or Scheme providers, the FSC Member must incorporate within**

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the Constituent Document all the changes necessary to ensure compliance with the requirements of this Standard.

- 6.2.1 The movement within the industry towards Scheme pricing uniformity will be accelerated where the Constituent Document of a Scheme is brought into line with the requirements of this Standard.

7 Application of Materiality

- 7.1 **The requirements in this Standard apply to the pricing of interests in a Scheme where such application is of material consequence. Failure by a Scheme Operator to adopt or implement a requirement is material if such failure has the potential to adversely affect:**

- **an Investor's equitable interest in the Scheme Assets;**
- **other users of Scheme prices;**
- **a proper assessment of the investment performance of the Scheme, where investment performance is referenced to unit prices; and**
- **a decision by an Investor to allocate scarce resources.**

- **In deciding whether an item is material, its nature and amount usually need to be evaluated together. Further information on materiality in relation to errors in unit pricing can be found in FSC Standard No. 17 – 'Incorrect Pricing of Scheme Units'.**

8 Definitions

- 8.1 **In this Standard:**

- **'Associate' has the same meaning as in FSC Guidance Note No. 5 'Industry Terms and Definitions';**
- **'Constituent Documents' of a Scheme means the rules and regulations under which the Scheme exists;**
- **'Constitution' has the same meaning as in FSC Guidance Note No. 5 'Industry Terms and Definitions';**
- **'Entry Price' means the Scheme price at which an Investor acquires an equitable interest in a Scheme;**
- **'Exit Price' means the Scheme price at which an Investor realises an interest in the Scheme;**
- **'Forward pricing' means that for an investor transaction received before instruction cut-off, the price will reflect a Valuation Point in the future (the price will be unknown at instruction time, and will be calculated in the future);**
- **'Historic pricing' means that for an investor transaction received before instruction cut-off, the price will reflect a Valuation Point in**

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the past, normally the close of the business day before instruction day for domestic assets (the price will often be known or be able to be accurately predicted at instruction time, and will often have been calculated before instruction time);

- **'FSC Member'** refers to a **'Full Member'** as defined in FSC's Constitution;
- **'Interest'** means an undivided portion of the equity of a Scheme;
- **'Investors'** has the same meaning as in FSC Guidance Note No. 5 **'Industry Terms and Definitions'**;
- **'Net Asset Value Price'** means the Scheme price used to determine the Entry Price and Exit Price;
- **'Operator'**, has the same meaning as in FSC Guidance Note No. 5 **'Industry Terms and Definitions'**;
- **'Prices'**, in relation to a Scheme, together mean the Entry Price and the Exit Price of that Scheme;
- **'Scheme'** has the same meaning as in FSC Guidance Note No. 5 **'Industry Terms and Definitions'**;
- **'Scheme Assets'** means the assets and liabilities of the Scheme, the valuation of which is determined in accordance with the FSC Standard No. 9 **'Valuation of Scheme Assets and Liabilities'**; and
- **'Valuation Point'** means the point in time at which a cut-off is made to value the Scheme's Assets and Liabilities.

9 Principles of Scheme Pricing

9.1 The process of determining Scheme prices in relation to a Scheme must meet the following criteria:

- it must be equitable;
- it must be documented and transparent;
- it must be applied consistently; and
- it must be regularly reviewed.

9.2 An equitable unit pricing process that treats all types of investor including different classes of investors fairly, and does not favour:

- transacting or non-transacting investors;
- current or future generations of investors; and
- different classes of investor (where applicable).

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9.3 An equitable unit pricing process must consider the impact of transacting investors on the Scheme. Consideration must be given to:

- **transaction cost factors;**
- **arbitrage opportunities;**
- **impact of backdating;**
- **frequency of pricing;**
- **suspension of pricing;**
- **frequency of asset valuation;**
- **rounding adjustments;**
- **booking interests in a Scheme; and**
- **distribution reinvestment plans.**

10 Equitable unit pricing processes

10.1 Transaction Cost Factor

10.1.1 Scheme Operators should incorporate a ‘transaction cost factor’ in Scheme prices where identifiable transaction costs exist with respect to either the acquisition or disposal of Scheme Assets. The amount of any transaction cost factor must not accrue to the Scheme Operator.

10.1.2 The inclusion within the pricing process of a transaction cost factor acknowledges that acquisition or disposal costs (e.g. brokerage and stamp duty) have been incurred by Investors in acquiring or disposing of Scheme Assets, so that the interests of non-transacting Investors are not diluted by the activity of transacting investors.

10.1.3 Scheme Operators must estimate transaction costs where they are incorporated into Scheme prices and review the methodologies used to estimate the transaction costs at least annually. The methodology to estimate transaction costs must be documented and the process transparent.

10.1.4 The estimation of transactions costs must be limited to costs incurred at the point of trade execution and must exclude associated costs such as transaction based custody fees.

10.1.5 Where practicable, brokerage costs incurred in exchange for provision of research must also be excluded. All such costs must be recorded as expenses of the fund.

10.1.6 In determining a transaction cost methodology, Scheme Operators must consider:

- changes to fundamentals of the Scheme or the market, for example, movements in the stamp duty rate;

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- an allowance for market impact where the Scheme holds thinly traded assets with significant bid-offer spreads (if this has not been previously taken into account in valuing the thinly traded asset);
- an allowance for the netting effect of applications and redemptions where this has, in the past, had a significant and regular effect on the amount of transaction costs actually incurred by the Scheme; and
- the general direction of capital flows (ie, if the pool no longer accepts any contributions, only a selling cost allowance need be incorporated).

10.2 Arbitrage opportunities

10.2.1 Scheme Operators must understand and document the end-to-end pricing process and any aspects which may give rise to the opportunity to arbitrage.

10.2.2 Scheme Operators must understand how the design of the pricing process across legacy, current and proposed products may give rise to the opportunity to arbitrage.

10.2.3 Opportunities to arbitrage exist in Historic Pricing environments and may exist in a Forward Pricing environment.

10.2.4 Opportunities to arbitrage may arise from:

- unit prices being calculated less frequently than the frequency of asset valuations;
- unit prices being calculated less frequently than the frequency of transacting;
- an investor transaction received before instruction cut-off receiving the last calculated price;
- delays within the end-to-end asset valuation process including service provider processes;
- the availability of asset valuation information at instruction cut-off time; and
- the release of price sensitive information prior to these being incorporated into scheme pricing.

10.2.5 To determine whether a delay exists in asset valuation that can be exploited by Investors, the relationship between the Valuation Point(s) of the asset(s) and instruction cut-off times must be investigated.

10.2.6 Within fund-of-fund structures, additional delays may exist when investing into external unit trusts. Scheme Operators must understand the end-to-end pricing process to determine the extent of any delays in asset valuation.

10.2.7 Scheme Operators must consider the adoption of a response plan, to be invoked when an event has occurred that creates an arbitrage opportunity. Actions may include suspension of scheme pricing and / or changes in the frequency of scheme pricing.

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10.2.8 Scheme Operators must have a process in place to minimise arbitrage opportunities.

10.2.9 Appropriate steps may include but are not limited to:

- monitoring investor activity to identify activity that may constitute arbitrage;
- introducing fees for frequent switching; and
- introducing a period of delay to applications or switches to make arbitrage uneconomic.

10.2.10 Where inappropriate activity has been identified, Scheme Operators must determine the facts of the case and what powers are available to the Scheme Operator (if any) to address the inappropriate activity. Scheme operators must document decisions made (including the decision to take no action).

10.3 Impact of Backdating

10.3.1 Scheme Operators must have a backdating policy in place, documenting under what circumstances impacts of backdating will be funded by the Scheme Operator.

10.3.2 Regardless of approach, the Scheme Operator must have a process in place to monitor the backdating of transactions and fund any unreasonable impacts as defined by the Scheme Operators policy.

10.3.3 Backdating occurs when the unit price given to a transaction is different to the unit price that must be used to process other transactions in the Scheme on the same date. Backdating can occur as a result of processing turnaround times and processing errors. Backdating is a feature of unitised products and the impact can be either positive or negative. Impacts of backdating are not borne by the transacting investor but by non-transacting investors.

10.4 Frequency of pricing

10.4.1 Where interests in a Scheme are transacted on a basis less frequently than daily, Scheme prices must be determined at least as frequently as Scheme interests are transacted. Scheme prices should generally be determined on a daily basis.

10.5 Suspension of pricing

10.5.1 A Scheme Operator must suspend transactions in the interests of a Scheme where Scheme prices cannot be determined. The Scheme Operator must also consider suspending transactions in the interests of a Scheme where a material dilution of Investor's interest will occur (such as when a significant market movement has occurred).

10.6 Frequency of asset valuation

10.6.1 Valuation of Scheme assets and liabilities should occur as frequently as interests in the Scheme may be transacted. Where less frequent valuations

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are made (typically due to the nature of the asset), Scheme operators must satisfy themselves that equity is maintained between transacting and non-transacting investors.

10.6.2 Scheme prices are determined from a valuation of Scheme Assets made at a specific point in time (the 'Valuation Point'). By entering into a transaction in Scheme interests immediately after a Valuation Point the Investor can ensure that the price he or she pays is as close to the true value of an interest as possible.

10.7 Rounding adjustments

10.7.1 Scheme operators must not accrue any rounding adjustment. Rounding adjustments must remain in the fund at all times.

10.8 Booking Investments in a Scheme

10.8.1 Interests in a Scheme must not be issued prior to receipt of funds by the Scheme, where potential for a material dilution of investor interests exists.

10.8.2 The practice of issuing, reserving, or booking units to an investor in a Scheme prior to the receipt of funds (which includes receipt of drawdown directions under direct debit arrangements, receipt of promissory notes or negotiable instruments or other rights to payment or intangible property, provided that they are permitted by Scheme constitutions, and receipt of funds into the Scheme application account) is not acceptable (where this is inconsistent with the constitution or otherwise in breach of law). This is because the interests of existing Investors may be diluted by the amount of any increase in the value of the Scheme Assets attributable to that Investor prior to the receipt by the Scheme of the Investor's application monies. These monies could have been invested for the benefit of all Investors with interests in the Scheme.

10.8.3 Where Scheme operators invest into internal Schemes as a means of gaining exposure to particular asset classes it is acceptable practice to issue units prior to the receipt of funds on the proviso that funds will be received within the settlement date cycle applicable to the underlying assets of that Scheme (e.g. trade date plus 3 for equities). This enables Scheme operators to trade between asset classes whilst still maximising exposure to the market.

10.9 Distribution Reinvestment Plans

10.9.1 Interests in a Scheme issued in relation to a distribution reinvestment plan must be issued at a Scheme price and using a methodology which ensures equity is maintained.

10.9.2 Where the Investors are entitled to an income distribution from a Scheme, the entitlement generally arises at a point specified in the Scheme's Constituent Document. An Investor may be required, or may elect, to utilise an income entitlement as an application for additional interests in a Scheme. The calculation of an amount of an Investor's income entitlement may not be completed for some

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time after entitlement, and therefore the distribution payment date is likely to be different to the income entitlement date.

10.9.3 The reinvestment process used and the date on which the reinvestment price is based must not materially disadvantage any particular Investor or Investor with respect to any other Investor. The reinvestment price must be the Net Asset Value price.

10.9.4 Election by an Investor to utilise an income entitlement as an application for additional interests in a Scheme must be made before income has been distributed from the Scheme. This is to avoid Investors gaining advantage through hindsight actions.

11 Documented and transparent unit pricing processes

11.1 Members must have a policy framework in place that documents the adoption of the Principles of Scheme Pricing. The policy framework must include, at a minimum:

- **Delegated authorities and accountabilities;**
- **Reporting requirements;**
- **Processes to confirm the completeness of and compliance with policies;**
- **Training requirements for policy awareness;**
- **The alignment of procedures to policies;**
- **Ongoing review of policies and procedures; and**
- **Outsourcing arrangements (where appropriate).**

12 Consistent unit pricing processes

12.1 Scheme Pricing policies must be applied consistently and exceptions to documented policies, processes and procedures must be clearly documented at the time an alternative policy, process or procedure is used.