GUIDELINES TO GOOD INVESTMENT REGULATION[1]

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Investment Committee
FIAP

[1] This document has been prepared by the ad-hoc committee appointed by the FIAP Investment Committee on the basis of an Index approved by such Committee and including the comments on the First Draft presented by the attendants to the Investment Committee Meeting held in Lima, Peru, on November 3, 2004, and comments on the Second Draft, which were sent by electronic mail. The Editing Committee of this document is made up of Francisco Margozzini, the General Manager of the Chilean Trade Union Association of Pension Fund Managers (AFP); Joaquin Cortéz, Investment Manager of AFP BBVA Provida and Augusto Iglesias, Partner of PrimAmerica Consultores and Exterrnal Advisor to FIAP. Mrs. Gladys Otarola, the Executive Secretary of Fiap, collaborated with the Committee.

EXECUTIVE SUMMARY

Thirty-four (34) *Guidelines* for the regulation and management of mandatory pension fund investments are put forward, organized into nine (9) sections. The *Guidelines* are applicable to defined contribution mandatory pension fund programs based on individual funding, to the companies that manage such programs in a free-market system and the supervising agency of such. Furthermore, and whenever pertinent, the *Guidelines* are applicable to the agencies that hold custody of the financial instruments representing the pension fund investments, the intermediaries and the external agencies that render portfolio management services to the pension funds. The *Guidelines* do not directly refer to occupational, defined benefit and voluntary pension programs.

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A. INTRODUCTION

1. This document puts forward Guidelines for the regulation and management of mandatory pension fund investments.

   These Guidelines are based on – in FIAP's opinion – the best current procedures in member countries and the experience acquired by the industry itself in pension fund management.

   Furthermore, the following documents have been examined during the drawing up of these Guidelines:

   - *"Guidelines for the investment of Social Security Funds".* ISSA Technical Commission on Statistical, Actuarial and Financial Studies/Technical Commission on Provident Funds and Allied Schemes (July, 2004).
   - *"Principios de Regulación y Supervisión en Pensiones"(Regulation and supervision principles in Pensions)*. AIOS (November, 2003).
   - *"Draft Guidelines on Pension Fund Asset Management".* OECD Working Party on Private Pensions (Nov. 2003).
   - *"Revised Guidelines for Pension Fund Governance".* OECD Working Party on Private Pensions (Nov. 2002).
   - *"Selected Principles for the Regulation of Investments by Insurance Companies and Pension Funds" (Annex).* OECD (March, 2002).

2. These *Guidelines* are applicable to defined contribution mandatory pension fund programs based on individual funding, to the companies that manage such programs in a free-market system and the supervising agency of such. Furthermore, and in all pertinent matters, the *Guidelines* are applicable to the agencies that perform the custody of the financial instruments representing the pension fund investments, the intermediaries and the external agencies that render portfolio management services to the pension funds.

   These *Guidelines* do not directly refer to occupational, defined benefit and voluntary pension programs.

   These Guidelines must be complemented with investment Guidelines for life insurance companies that offer pension life annuities.

3. The main purpose of the Guidelines is to provide controlling agencies and the industry with a reference framework that will help to design and put forward efficient and effective regulations which should contribute to the pension fund

investment process being applied in a way that is consistent with the purpose of the pension system and to the benefit of its members.
Furthermore, the aim is to encourage the adoption by FIAP member countries of a basic set of standard regulations that will help to avoid malpractice and contribute to the stability of the pension system.

In any event, the Guidelines are not a proposal of specific regulations. Each country, based on its own reality, must decide on the specific control procedures for its respective pension systems.

4. The existence of an appropriate legal framework, of fund managers that assume their trustee role and supervisors that act professionally and efficiently, are necessary but not sufficient conditions for protecting pension funds.

   It is also necessary for the members of the system to be adequately informed and assume the responsibility of controlling the performance of the fund managers they themselves have chosen

   At the same time, it is important for the fund managers and the authorities to promote the necessary improvements to the legal framework that governs the capital market and which is applied to the different issuers of public offer securities which are the object of investment by the pension funds.

5. In an individually funded system, the profitability of the funds has a decisive influence on the level of pensions. Consequently, the adoption of the most suitable regulatory and supervisory system for pension fund investment is a decision that is critical for the outcome of the system.

   There are different alternative models for pension fund regulation. FIAP maintains that the most suitable regulatory system for individually funded mandatory plans must combine sensible pension fund management criteria with a certain reduced number of explicit quantitative limits whose main purpose is to control investment of the funds in assets issued by companies related to the fund managers; to limit the investment of funds in high risk or not very liquid assets; to ensure adequate diversification among issuers and to differentiate between different types of funds or investment strategies.

   Although the application of limits and specific restrictions on investments may be necessary in the initial stages of development of an individually funded mandatory pension system, the regulatory system must move towards self-regulation, granting ever greater degrees of freedom in the decisions of the fund managers.

6. Following on this introduction, the document puts forward a total of 34 Guidelines organized into nine (9) sections:

   - Purpose and characteristics of pension fund investment regulation. (3 Guidelines);
   - Corporate government of pension funds (5Guidelines);
   - Supervision of pension fund investment (5 Guidelines);
   - Control of investment in parties related to the fund manager (3 Guidelines);
   - Valuation of assets (5 Guidelines);)
   - Performance measurement (1 Guideline);
   - Investment ceilings for pension funds (4 Guidelines)
   - Custody (4 Guidelines);
   - Transaction procedures (4 Guidelines).

   Each section begins with a brief description of the purpose of the respective set of Guidelines. After the presentation of each Guideline, its scope and implications are explained.

B. GUIDELINES

I. Purpose and characteristics of pension fund investment regulation

Purpose of investment regulation*:*

Mandatory pension fund investment regulations pursue the following principal goals: to ensure that the pension savings are used only for the purpose of the pension system; to avoid possible conflicts of interest between the contributors and the fund managers; to limit financial risks and reduce the risk of fraud. The regulations must also enable the members of the system to choose the portfolio best suited to their preferences. Finally, in some circumstances, the regulations also aim at limiting supervision costs and the cost of keeping the members informed.

Therefore, the aim of the regulations is firstly to preserve, and then to increase, the value of the pension savings of the members of the system throughout their working lives.

Guidelines:

I.1 Pension fund investments must have the sole purpose of achieving maximum profitability of the funds accumulated during the lifetime of the worker, and adjusted to the preferred risk level.

The purpose of pension savings is to finance pensions; therefore the regulations must tend to maximize the accumulated capital in the individual account during the working life of the member; this demands that fund managers seek the greatest profitability and at the same time take precautions to avoid the possible risk of loss of value of the savings. Specifically, the investment portfolios with greater expected future value are also subject to greater risk of variation in the final accumulated profitability. Therefore, the fund managers and the regulations must balance both objectives.

From the point of view of each fund manager, the investment horizon is greatly influenced by the frequency with which the public evaluates the results and by the expected constancy of their respective member portfolio. This fact represents another challenge for the regulations, as the undeniable freedom of the members to choose the agency that manages their savings and the convenience of having periodic measurements of results, must be balanced against the need to promote investment policies whose purpose is to maximize long term profitability.

Investment regulation must not be used as an instrument to further any other economic or social purpose, whatever its merit may be, other than the purpose of the pension system. This implies that the pension funds must not be used to forge industrial policy, to finance projects or activities under conditions that do not strictly correspond to those prevailing in the market at the relevant time, nor to stimulate the development of any specific market. On the contrary, the contribution that pension funds can make to the economic and social development of a country increases when such are efficiently invested according to market conditions and for the exclusive purposes of the pension system.

I.2 The regulations must enable investments to diversify into different financial instruments, issuers and economic and geographic sectors.

Pension funds must be authorized to seek out the financial instruments that offer the most attractive returns in the marketplace. Nevertheless, they must simultaneously diversify their investments to avoid undue exposure to risk. An adequate diversification of pension funds is a necessary condition for controlling investment risks. However, individuals have different risk preferences, so they should be able to opt for funds with varying degrees of expected returns. Therefore, diversification requirements must not prevent the member from choosing between funds with greater or lesser exposure to variable income and greater or lesser average term. In any case, each type of fund must be suitably diversified.

International diversification of pension funds contributes to the reduction of variability on returns and the improvement of return levels expected in the long term. The benefits of international diversification become more meaningful the more underdeveloped local markets are and the less the economic cycles of the country are in tune with the rest of the world.

Whatever the currency in which pension fund liabilities are expressed, diversification in currencies can also be convenient, especially when there is a negative relationship between local market returns and the value of the currency. Thus, besides authorizing fund investment in instruments issued in different currencies, they should not be indiscriminately required to have complete coverage of the exchange risk.

I.3 *The* ***regulations must adapt to the realities of the capital markets and evolve in tune with the development of such, with supervision capability and the characteristics of the legal system.***

The detailed design of investment regulations inevitably depends on the conditions of the capital markets. The availability of different instruments, the mechanisms for performing transactions, the custodianship alternatives, the possibility of recurring to independent risk classification and the quality of financial information, are all elements that influence the design procedures of investment regulations.

Supervision capability is also not unchangeable over time. The process of pension fund accumulation goes hand in hand with greater experience of the supervisors and the industry, with increased availability of information and ever-increasing financial and social security awareness among the public. These three tendencies create conditions that enable gradual progress toward regulatory systems that give greater degrees of freedom to fund managers to decide on the structure of their investment portfolios.

The characteristics of the investment regulation system also depend on the justice administration system prevalent in the country, because the application of the concept of trustee liability requires the judicial system to be capable of effectively acting as an instrument whereby individuals (or the supervisory agency) can resolve their differences with the fund managers.

Thus, the existence of more developed capital markets, more experienced supervisors, better informed individuals, and legal systems that enable punishment of those that do not meet their trustee liabilities, make it possible for investment regulations to offer greater degrees of freedom to fund mangers to structure their investments as they see fit. Consequently, there is no unique set of pension fund investment regulations that serves the purposes of the pension system equally well at all times. The investment regulation system must evolve in relation to the results of the system and change in the surrounding conditions, gradually moving forward toward systems with a greater self-regulation component.

Nevertheless, the convenience of adopting a dynamic attitude to the design of regulations must be balanced with the necessary stability of the regulatory framework, an essential condition for fund managers to be able to perform their activities within a context of judicial certainty. Furthermore, possible changes in the regulations must never provoke a massive restructuring of the fund managers' investment portfolios. This implies that the regulations must always evolve from a point of greater restrictions to one that offers greater freedom to the fund managers, and never in the opposite direction. In this way, changes that are introduced must enable the opening of new investment possibilities and not limit any previously existing ones.

II. Corporate government of the pension funds

Purpose:

Mandatory pension funds are managed by companies with a limited purpose ("pension fund managers"), incorporated according to legal requirements and which are specially licensed to fulfill this role. In their condition of managers of third party resources, such agencies have trustee liabilities, the scope of which must be defined in the regulations. The regulations must also define the role played by other independent agents, such as auditors and risk classifiers, in the definition of the risk involved in pension fund investments.

Guidelines:

II.1. The net worth of the pension funds is different to and independent of the net worth of the fund manager and other assets that it may possibly manage.

Pension funds are made up of the sum of contributions made by its members – or third parties on their behalf – plus the product of the investments. These assets belong to the members of the system and not to the fund manager, and must be kept apart – legally, accountably and financially – form the assets of the fund manager itself and other assets that it may possibly manage.

The essence of these Guidelines does not change in cases where the fund manager is legally required to finance and maintain its own reserves that guarantee the results of the pension funds, and where, due to legal provisions, such reserves must be invested in the same fund.

The fund manager, by virtue of a contract, is obligated to invest the pension funds in accordance with legal regulations and with the purpose of obtaining suitable profitability under certain risk conditions, but it does not own them, nor can it freely dispose of them.

Each member of the system must have individual property rights on the funds corresponding to the balance of his individual account. Pension funds must be immune to attachment.

II.2 Pension fund managers have trustee liability for the resources they manage.

When managing funds, fund managers must exercise all the care, diligence and expertise they would exercise in the management of their own resources.

Fund managers must apply their expert know-how and must under no circumstances assume risks that they would not be prepared to take in case the managed funds were theirs.

By virtue of its trustee liability, the fund manager must seek to establish an organization and procedures that will allow it to effectively comply with regulations and its own policies and investment strategies, and must apply the necessary resources for adequately exercising the function of pension fund investment.

The management liability for the investment portfolio must be defined within the organization.

The personnel responsible for investment management must be fully qualified for performing their tasks. It would be convenient for the Board of Directors of the fund manager to appoint a special Committee responsible for setting out the internal procedures to be used in investment management and supervise compliance therewith. This committee must be made up of individuals with professional knowledge and experience in financial matters.

The pension fund must have an external auditor that must regularly report on compliance with legal norms and the quality of compliance with internal procedures in investment management matters. It would be convenient for the external auditor, or in its absence, the professionals responsible for the external auditing, to be renewed periodically.

II.3 The pension fund investment policy must be known by the public.

The Fund Manger must approve the investment policy and its modifications. The Investment Policy, and any other modification thereof, must be made known to the public. The Investment Policy must make specific reference to the guidelines that the fund manager voluntarily decides to adopt and which adequately complement legal regulations in force.

When managing pension funds the fund managers must ensure compliance with the approved Investment Policy.

In circumstances in which the fund managers manage more than one pension fund, the Investment Policy must clearly distinguish between each one of them.

II.4 Fund Managers must exercise all the right corresponding to pension funds in their role as investors in shares, bonds and other financial instruments.

Pension funds must seek to invest in different financial instruments, subject to the same rights and liabilities as any other investor in the corresponding securities. In general, it is not convenient for pension funds to be invested in securities that have preferences or exclusive liabilities for pension funds attached, and which are not made extensive to other investors.

In their role as investors for a pension fund, the fund managers must participate in all pertinent events and exercise their due rights. Therefore, fund managers must attend the Shareholders Meetings of companies in which they have invested for the pension fund, and vote when pertinent. The fund managers must also attend Bond Holders Meetings, Investment Fund and Mutual Fund Contributors meetings, and other similar events. Exceptions to this policy may be justifiable only in such cases in which the respective security represents a very low percentage of the pension fund. The regulatory framework must allow fund managers to exercise all legal actions corresponding to their trustee liabilities.

Fund managers have management liabilities for a financial investment portfolio and are not business managers. Therefore, they must not participate in the management of the companies in which they invest the resources of the pension fund. Nevertheless, the regulations must not prevent the fund managers from expressing their opinion on the running of the business to the responsible parties in such companies.

It is convenient for companies in which pension funds are invested to be subject to corporate government rules that are exhaustive and known.

II.5 The fund manager must guarantee access by the supervising agency and the public to information on the composition and variety of its investment portfolio, and the results obtained from the investment management process.

Whatever the regulation and supervision system of pension fund investments adopted, the supervising agency must have access to information that will enable it to monitor the investment management of the different fund managers. It is also important that the external auditing agencies, and should it be the case, the external risk classifiers, should have access to such information.

The fund managers must guarantee all such agencies timely access to relevant information.

The public must also have prompt and timely access to information regarding the characteristics of the pension fund investment portfolios and the management results of the different fund managers. Furthermore, when there is a possibility of choosing between funds with different characteristics, the public must have access to the comparative and background information that will enable it to make an informed decision when deciding between different funds. In order to facilitate the interpretation of the information by the public, rules may be imposed whereby uniform presentation models of such information are established and compliance with which is mandatory for the fund managers. These regulations must promote the comparison of long term results.

III. Supervision of pension fund investment

Purpose:

The responsibility for ensuring adequate management of pension fund investments is mainly up to the fund managers. In order to meet this responsibility, the fund managers themselves must establish internal control mechanisms, which are complemented by the actions of independent agencies such as auditors and risk classifiers. Nevertheless, as pension systems originate in a legal mandate, it is justifiable for internal control mechanisms to also be complemented by external supervision. The purpose of the Guidelines described in this section is to define the role of the external supervisor in the control process of pension fund investments.

Guidelines:

III.1 The supervising agency must ensure that the pension fund investment process complies with all pertinent legal regulations.

The supervising agency is especially liable for ensuring that the pension fund managers comply with the rules that govern pension fund investment management, and whenever necessary, apply the sanctions stipulated in the respective regulations.

The supervising agency must not interfere in the investment decisions taken by the fund managers or assume responsibility for such. If, for whatever reason, the fund manager should lose the right to manage the funds, the supervising agency must apply the relevant procedures to ensure the continuity of management while the participants decide on the transfer of their funds to another fund manager.

III.2 Supervision must be founded on technical and professional criteria and must be timely and impartial.

Supervision must strictly adhere to the legal framework. The creation of a series of regulations of a paralegal or administrative nature that introduce unjustifiable complications in the pension fund investment process must be avoided. It is recommendable that the supervising agency place greater emphasis on ensuring compliance with the purpose rather than on procedures.
The supervision process must be impartial and must in no way prefer or make exceptions in favor of any particular fund manager that are not generally applicable to the entire industry.

The fines and sanctions must be well-founded, proportional to the breaches and infringements committed, appropriate and known beforehand. Such fines and sanctions must only be applied when laws and secondary regulations are not respected, and they are not applicable when founded merely on the impression or subjective opinion of the supervising agency regarding the quality of management.

Similar breaches must be subject to the same fines and sanctions, regardless of the fund manager.

The fines and sanctions must always be open to appeal to the same supervising agency. Furthermore, in case the affected fund manager deems it necessary, the possibility of appealing to agencies other that the supervising agency itself, and which must be under a different jurisdiction, must exist.

III.3 The supervising agency must ensure that the regulatory framework of pension funds investment is not used as an instrument for furthering ends foreign to the pension system.

Potential conflicts exist between the sole purpose of pension fund investment and other social and economic policy objectives. Consequently, and as the supervising agencies are frequently part of the public sector, there is also a risk that its procedures be used for the purpose of applying the pension funds to the financing of projects or activities that the fund managers, in compliance with their trustee liabilities, do not consider to be the purpose of investment.

In order to avoid such risks, the greatest possible independence of the supervising agency from the political power must be assured. Furthermore, the supervising agency must have a clear and specific mandate, founded on legal norms, to ensure that fund investments are decided only on the basis of the purpose of the pension system. The supervising agency must express its opinion before the pertinent agencies whenever changes in the regulatory framework of the pension system, that are contrary to this principle, are discussed.

From this perspective, and as long as the due coordination and exchange of information between the supervisors of the banking and financial sectors is assured, specialized supervision of the pension funds has some important advantages. Therefore, if it is decided to integrate the supervision of pension funds with the supervision of other entities in the financial sector, the maximum autonomy of the unit that assumes the respective responsibility must be assured.

III.4 The supervising agency must promote the necessary changes to the investment regulations to ensure that they adapt to market conditions.

The investment regulation system adopted, and the design of the specific pertinent regulations, depend on the conditions of the local capital market, of the supervision capability, the maturity of the pension system and the characteristics of the justice administration system prevailing in the country. As all these characteristics are dynamic and change continually over time, it also becomes necessary to modify pension fund investment regulations whenever conditions so require.

The supervising agencies play a central role in this process, promoting timely changes that enable the fund managers to take advantage of the opportunities the market offers. In any case, it would be convenient for the general legal framework that defines the investment regulation system to be used, and the main specific regulations, to be determined by law. If the law grants the supervising agency –or another administrative agency – the power to establish the more specific and detailed investment regulations, care must be taken to endow this process with a minimum of good judgment, that it is founded on reasoning of a technical nature and always aims at broadening and not restricting the investment opportunities of the pension funds.

III.5 The supervising agency must warrant the timely, complete and clear disclosure of information regarding pension fund investments.

In order to be able to make informed decisions, the public must have access to timely, complete and clear information regarding pension fund investments.

The supervising agency must ensure that this information is available for the members of the system. Such information must make reference to the investment policies of the funds and the management results. It would be particularly recommendable for the supervising agency to ensure the routine disclosure of consistent and standardized information on the structure of the pension fund investment portfolios and the historical profitability results, measured over a relevant term.

The supervising agency must also contribute to the social security education of the public, introducing initiatives that help the citizenry interpret the information on pension fund investment and understand the consequences of their decisions.

The information provided by the controlling agency complements, but does not substitute, that provided by the fund managers themselves. Information distribution and social security education efforts, performed jointly by the industry and the controlling agency, can be especially effective.

IV. Control of investments in parties related to the fund managers

Purpose:

The corporate equity of the fund managers is small in comparison to the volume of funds they manage. Therefore, the benefits that individuals related to the fund manager (or individuals in whom the controllers may have special interest), can obtain from transactions that damage the pension fund, could be potentially greater than the costs derived from a possible legal sanction or the loss of reputation in case such conduct is made public. On the other hand, the legal system may possibly not provide efficient legal instruments to punish those that do not meet their trusteeship duties. Consequently, regulations are required to limit such conduct.

Guidelines:

IV.1 Pension fund investment in any financial instrument issued by agencies related to the fund manager, its controllers and principal managers, must be limited.

In general it is difficult to guarantee the independence of a fund manager to decide on the convenience of an investment or disinvestment in assets issued by related parties. Therefore, the existence of legal limitations that avoid excessive exposure of the fund in issuers that are parties related to the fund manager is appropriate, even when such investments are made in formal markets.

Furthermore, the investment policy of the Pension Fund must explicitly specify whether the fund manager is prepared to include assets issued by related parties in its investment portfolio or not.

IV.2 The buying and selling of assets of the pension fund to parties related to the fund manager must take place in formal intermediation markets and follow procedures that enable the participation of other possible interested parties.

For the purpose of avoiding the occurrence of intentional transfers of wealth from the pension fund to such individuals that are responsible for, and have direct knowledge of, the management of such, each time the fund sells or buys assets from them, it must be done in formal markets, at public and published prices, and using mechanisms that allow participation of third parties in the respective transactions.

IV.3 The private investments made by companies that manage pension funds, by members of their boards of directors, individuals responsible for the investment process and those who have access to privileged information regarding investment decisions due to their position, must obey established regulations.

When pension funds make up an important part of the capital market, their transactions may have some effect on the prices of the respective assets, which creates opportunities for individuals with privileged information on the operations to make profits or avoid capital losses.

Consequently, and in compliance with their responsibilities as managers of third party funds, it is important for the managing companies to adopt self-regulation codes that clearly and specifically define a reference framework for personal financial transactions performed by board members and management responsible for, and with knowledge of, the pension funds investment process. Specifically, these guidelines must limit the possibilities for the respective individuals to decide on personal or related third party investments on the basis of information they receive before the market, with regard to future pension fund transactions.

The aforementioned guidelines must make explicit reference to transactions between the managing company and the pension fund or funds that it manages.

V. Valuation of assets

Purpose:

The regulations must ensure that the pension fund assets are properly valuated and thus avoid intentional transfers of wealth and bias in investment decisions, and also to assure that trustworthy information is provided to the users and other economic agents.

Guidelines:

V.1 The assets in which pension funds are invested must be valuated preferably according to market value.

Within the context of defined contribution individually funded pension fund systems, the valuation of investments at market price contributes to avoiding intentional transfers of wealth between participants with greater or lesser information, and between the participants and the fund managers.
The market prices to be used for valuation must be representative and the most recent possible. As daily transactions of all instruments do not always occur– especially in small markets - and even if they do occur, in some cases the prices of such are not necessarily representative (because, for example, they may be very small transactions destined to "set" prices), it is necessary to define procedures applied across the board by all fund managers to determine the market prices to be used in valuation.

Such procedures must not be based on formulas based o average prices over some period of time.

V.2 When there is no market price, the regulations must estimate such value using strict technical criteria.

When a relevant market price for a specific instrument does not exist (which can occur for several reasons, such as the absence of recent transactions of the instrument, or because the transactions are for non-representative amounts), it is necessary for the regulations to define the procedure to be followed in order to establish such price, on the basis of the economic value of the instrument.

In the case of fixed income instruments and financial intermediation, it is recommendable to define families of instruments with similar characteristics and estimate the missing prices on the basis of the observed prices of the other instruments of the respective family. In the case of securities that are not generally traded, the purchase prices of the instrument can be adjusted regularly in such a way that the risk premium at the time of purchase remains constant.

For such variable income instruments that are not regularly traded on the market, the economic value must be obtained through independent agencies, which must be obligated to use conservative valuation criteria.

V.3 There must be a sole, clear and consistent valuation methodology for the valuation of investment instruments which must be permanently upgraded taking into account the opinion of different specialists.

At each moment in time, there must be one only price for each asset, whatever the pension fund that has invested in it; it must be known to the market, and all the fund managers must use that one only value when valuating their respective portfolios.

In order to guarantee this result, the valuation methodology must be common to all the pension funds, so that each one of the instruments is equally valuated in the different investment portfolios. Furthermore, it is important for the methodology to be clear and precise in order to avoid interpretations that produce different values. Small differences in the way the instruments are valuated can create unwanted bias in the investment decisions of pension fund resources, and therefore the valuation methodology must be sufficiently specific to assure one only result for each asset.

The valuation methodology must be of public knowledge, as transparency makes the existence of valuation malpractice more difficult.

The valuation methodology must be permanently updated and improved in order to include new financial instruments and adjust to changes in the market. Such process must be transparent.

V. 4 The valuation frequency must be established according to the frequency of pension fund transactions.

The frequency with which an investment portfolio must be valuated is the result of a compromise between the need for frequent valuation (in order to avoid undesirable transfer of wealth and provide the public with information that will enable it to compare between funds) and the associated costs.

In the case of mandatory individually funded systems, which usually have daily movements (inflow and outflow) of the pension funds, which can include the transfer of resources from one pension fund to another and the withdrawal or deposit of voluntary savings, a daily valuation of the investment portfolio is required.

V.5 An independent agency without conflicts of interests must be responsible for the calculation of the valuation prices.

The calculation of the prices of each one of the assets in which pension funds are invested must be performed preferably by a third party, different to the fund manager and the issuer of the securities, that has no conflicts of interests.

Although, in theory, the existence of a sole, integral, detailed, clear and consistent methodology would assure an equal price or value for any single security, regardless of the institution that valuates it, it is equally probable that interpretation problems would arise which could lead them to an inappropriate application thereof. Therefore it would be convenient to leave the responsibility for the valuation process in the hands of one sole agency. In case there is more than one, the controlling agency must verify that they all provide identical market prices.

In general, it is not convenient for the supervising agency to determine the valuation prices.

VI. Performance measurement.

Purpose:

In order for the participants to be able to take adequate decisions, they require information on investment policies and portfolio characteristics, including background information on the historical performance of such. The performance, in turn, must be measured both in terms of the returns of the investment portfolio and its risks.

Guidelines:

VI.1 Members must be informed both of the return and the risks associated to the different pension funds.

Pension Funds are authorized to invest in many kinds of assets, some of which will have correlated returns. As a result of the volatility of the financial markets, the price variations of such assets make the pension funds susceptible to equity losses during transactions. For the purpose of managing and limiting the market risks in which the Pension Funds may incur, it is necessary to be able to measure them. This measurement is also necessary for the global risk of the portfolio to be in accordance with the risk tolerance of the participants.

It is also important for the comparison between different fund management companies to be made not only on the basis of return, but also on the risk incurred (if risk is not controlled, the ability of a fund manager may occasionally be overestimated).

VII. Limits of pension fund investment

Purpose:

The fundamental purpose of investment limits is to assure adequate diversification of the investment portfolios and ensure that excessive risks are not incurred, contrary to the purpose of the pension system. Other purposes could be to make sure that the risk profile of the funds is consistent with the risk tolerance of the participants and to reduce possible conflicts of interest.

Although they are necessary, investment ceilings must be as few as possible and must be applied equally to all fund managers and funds of the same type.

Guidelines:

VII.1 Pension funds must only be invested in previously authorized types and categories of instruments

Pension Funds must only invest in assets that are expressly authorized. Nevertheless, the list of authorized assets should, in general, include all the categories that are generally traded on the market, excluding only those that are not recommendable due to some particular characteristics or because of their possible immaturity in the market or that of the pension fund itself.

It is usually not appropriate to prohibit foreign investment and variable income securities, as that would negatively affect the adequate diversification of the portfolios. The use of derivatives must be allowed as it grants greater flexibility to the management of the investment policy. However, these must be used carefully and basically to cover existing risks in the pension fund portfolio.

The list of authorized assets should not constitute an investment recommendation for pension funds.

VII.2 The investment ceilings structure must be consistent with the purpose of maximizing the return and/or reducing the risk of the portfolios.

The investment ceilings must be defined as "maximum limits" and be consistent with the purpose of achieving an adequate diversification of the portfolio. Therefore, they must not excessively restrict the range of permissible investment strategies of the fund managers.

"Minimum" limits of investment are not acceptable for any category of assets, as they could have the effect of preventing disinvestment in assets considered undesirable by the fund managers. The only exception to this rule occurs when the fund managers are authorized to manage different pension funds, each with distinctive characteristics. In such cases, minimum limits are useful for assuring sufficient differentiation between each fund.

When defining limits structures, the sole consideration must be the purpose of the pension system, and any other consideration must be avoided. In particular, the pension fund investment ceilings structure must not be designed with the purpose of assuring financing for the public budget or for promoting other social and economic programs whatever their specific merit may be.

The sum of the different ceilings that are eventually fixed must always leave the fund managers sufficient room to choose between the different authorized assets.

There must be a procedure that allows the pension funds to exceed the set limits under special circumstances.

VII.3 Pension fund investment in certain authorized assets must be subject to special limits.

Pension funds originate in a social security mandate, and therefore certain special limitations for investing in assets with specific characteristics are justified. The following limitations appear to be specifically appropriate:

a) *High solvency risk assets.* Investment in high solvency risk assets must be strictly limited. This is due to low public tolerance to capital loss in the pension funds and the consequent high political risk associated to events of this nature. Therefore, it is not convenient for pension funds to invest in securities with high credit risk.

   Therefore, it is recommendable that the direct investment of Pension Funds be limited to instruments that have "investment level" risk classification granted by a classification agency with authorized procedures. In those countries where authorized classification agencies do not exist, their development must be encouraged.

b) *Investment in an issuer or issuers belonging to the same business group.* This must be restricted to a certain percentage of the total assets being managed.

c) *Related individuals.* Investment in debt or capital instruments of issuers related to the property of the Pension Fund Manager must be strictly limited.

d) *Limitations to the property of a company.* For the purpose of balancing the due exercising of the political rights common to all shareholders, with the risk of interference in matters that are the concern of the management of the companies, it is advisable to limit the direct participation of the Pension Funds to a maximum percentage of the equity of a specific company.

e) *Low liquidity assets not registered in any official market.* Such assets must be subject to demanding approval mechanisms and have lower maximum investment limits than liquid and registered assets.

VII.4 The ceilings system must differentiate between different types of pension funds.

In those countries where pension fund managers are authorized to offer their members more than one pension fund, the ceilings system must additionally seek to differentiate between them, for the purpose of offering members a wider range of portfolio options.

VIII. Custody

Purpose:

The regulations applicable to pension fund asset custody must guarantee the security of the financial instruments and the transactions performed with them (purchases, sales, collection of interest coupons, dividends and others).

Guidelines:

VIII.1 The majority of pension fund investment securities must be held in external custody, independent of the fund managers.

External custody in agencies not related to the fund manager contributes to the existence of double control (by the fund manager and the custodian agency) over pension fund transactions, to making instrument custodianship more professional and facilitating capital market transactions.

A minimum percentage of the investment portfolio that must necessarily be in external custody must be established. This percentage will depend on the conditions under which the capital markets operate in each country. It is not recommendable for securities representing more than 10% of the portfolio to be out of external custodianship.

To the degree that investment securities that are traded on the market are mostly held in custody, it will be possible to increase the percentage that must be held in external custody.

VIII.2 The external pension fund custodianship agencies must be specifically authorized to render such services.

The external custodianship institutions that render services to the pension funds, whatever they may be (Central Banks, Public Treasuries, banks, private depositories and others), must comply with strict requirements in matters regarding experience, capital, quality of physical installations, security and computer systems, insurance, external audits, and adherence to internationally accepted standards, to guarantee the existence and physical integrity of the financial instruments and the transactions performed with them.

On the other hand, it is not necessary for the pension fund foreign investment securities to be transferred to the country of origin to be held in custody by local custodianship agencies or depositories, but they can be held in custody in global custodian banks which at the same time maintain accounts in local or international depositories.

The custodians must be authorized by a competent agency that verifies that they meet the necessary conditions for rendering custodianship and market transaction liquidation services. The custodian must also be permanently controlled by a competent agency.

VIII.3 Private Custody vaults of the pension fund managers must be equipped with adequate security systems.

The fund managers are totally responsible for internal custody, which must have security mechanisms similar to those demanded of external custodianship agencies.

VIII.4 The liabilities of the custodian and the pension fund manager must be clearly defined in the regulations.

In the event of the loss of a title deed belonging to a pension fund in external custody, either due to misplacement, theft, fraud, destruction or any other cause, such event must not imply any loss for the members of the respective pension fund.

It is essential that the regulations clearly establish the liability of the different institutions in the case of the loss of an instrument, depending on the circumstances in which such events occur. Vague liabilities will not generate sufficient incentive for the different institutions involved to take the necessary security measures. They may also imply a subsequent lengthy judicial process to determine liabilities with the resulting uncertainty for the members and the agencies involved.

IX. Transaction procedures

Purpose:

The fund managers must act in such a way as to minimize the risks associated to the performance of transactions with resources of the pension fund they manage.

Guidelines:

IX.1 Securities transactions performed with the resources of the pension funds must only be performed in authorized markets.

The markets in which the pension fund transaction is authorized must comply with certain minimum requirements, such as having a sufficient number of buyers and sellers to thus ensure a correct setting of prices, an adequate control group, efficient negotiating mechanisms and available public information. Any exception to this rule must be clearly authorized.

The pension funds supervising agency will decide which the authorized markets are.

IX.2 When pension fund investments are channeled through agents, such agents must be specifically authorized to offer such services.

The pension fund managers could possibly be authorized to hire representatives for pension fund management. In these cases, such representatives must be authorized and adequately regulated by a competent financial authority, must have vast experience in the management of the assets which are the purpose of the mandate, and they must have a risk classification not lower than a previously defined level granted by a recognized classification agency.

As far as possible, regulation must be neutral between investment through representatives and direct investment by the investment department of the pension fund managers, both locally and internationally.

IX. 3. Any conflict of interests that arises at the time transactions are performed must be resolved in favor of the members.

The fund managers must establish criteria for resolving possible conflicts of interest that may arise between it and the pension fund it manages. In any case, the criteria must always give preference to the protection of the interests of the members.

IX.4 Asset buying and selling transactions between funds managed by the same fund manager must always be performed under market conditions.

When fund managers are authorized to manage more than one pension fund, the asset buying and sharing transactions between such funds must be regulated. The purpose of such regulation is to avoid intentional transfers of wealth between the members of each fund.

In order to achieve the foregoing purpose it would be recommendable for transactions between these funds to be performed on formal markets and that direct transfers of assets be authorized only in exceptional cases.

Furthermore, the following mechanisms can be used in a complementary manner: a) the establishment of previous registration of transactions and/or b) the use of different intermediaries (or the same intermediary with which one may operate directly through the use of exclusive and predefined codes) for each Pension Fund.